

DRUGSTORE COM INC

FORM 10-Q (Quarterly Report)

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Industry	Retail (Drugs)
Sector	Services
Fiscal Year	12/31

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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 2, 2006

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
(State or other jurisdiction of
incorporation or organization)

04-3416255
(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 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

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 1, 2006, the registrant had 93,024,050 shares of common stock outstanding.

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FORM 10-Q
For the three months ended April 2, 2006

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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 2, 2006	April 3, 2005
Net sales	\$ 104,109	\$ 99,573
Costs and expenses:		
Cost of sales	81,889	79,336
Fulfillment and order processing	10,177	10,285
Marketing and sales	8,977	6,963
Technology and content	3,942	2,932
General and administrative	4,294	4,429
Amortization of intangible assets	530	801
Total costs and expenses	<u>109,809</u>	<u>104,746</u>
Operating loss	(5,700)	(5,173)
Interest income, net	407	179
Net loss	<u>\$ (5,293)</u>	<u>\$ (4,994)</u>
Basic and diluted net loss per share	<u>\$ (0.06)</u>	<u>\$ (0.06)</u>
Weighted average shares outstanding used to compute basic and diluted net loss per share	<u>92,969,650</u>	<u>85,487,764</u>

See accompanying notes to consolidated financial statements.

DRUGSTORE.COM, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	<u>April 2,</u> <u>2006</u>	<u>January 1,</u> <u>2006</u>
	<u>(Unaudited)</u>	
Assets		
Current assets:		
Cash and cash equivalents	\$ 18,352	\$ 20,291
Marketable securities	23,565	26,172
Accounts receivable, net of allowances	35,128	34,214
Inventories	19,687	23,468
Prepaid marketing expenses	2,290	2,387
Other current assets	2,491	2,583
Total current assets	<u>101,513</u>	<u>109,115</u>
Fixed assets, net	15,966	15,839
Other intangible assets, net	6,897	7,427
Goodwill	32,202	32,202
Prepaid marketing expenses and other	5,408	5,980
Total assets	<u>\$ 161,986</u>	<u>\$ 170,563</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 54,123	\$ 58,177
Accrued compensation	3,130	3,426
Accrued marketing expenses	3,181	3,382
Other current liabilities	1,487	1,751
Current portion of long-term debt obligations	2,088	2,029
Total current liabilities	<u>64,009</u>	<u>68,765</u>
Long-term debt obligations, less current portion	2,279	2,685
Deferred income taxes	945	945
Other long-term liabilities	1,826	1,897
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, 93,010,886 and 92,904,652 shares issued and outstanding	835,543	833,589
Accumulated other comprehensive loss	(8)	(3)
Accumulated deficit	<u>(742,608)</u>	<u>(737,315)</u>
Total stockholders' equity	<u>92,927</u>	<u>96,271</u>
Total liabilities and stockholders' equity	<u>\$ 161,986</u>	<u>\$ 170,563</u>

See accompanying notes to consolidated financial statements.

DRUGSTORE.COM, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Three Months Ended	
	April 2, 2006	April 3, 2005
Operating Activities:		
Net loss	\$ (5,293)	\$ (4,994)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	1,458	1,603
Amortization of marketing and sales agreements	572	572
Amortization of intangible assets	530	801
Stock-based compensation	1,703	848
Other	4	(34)
Changes in:		
Accounts receivable	(914)	1,909
Inventories	3,781	(1,831)
Prepaid marketing expenses and other current assets	189	(279)
Accounts payable, accrued expenses, and other liabilities	(4,886)	(440)
Net cash used in operating activities	<u>(2,856)</u>	<u>(1,845)</u>
Investing Activities:		
Purchases of marketable securities	(10,873)	(30,209)
Sales and maturities of marketable securities	13,475	6,825
Purchases of fixed assets	(1,351)	(1,693)
Net cash provided by (used in) investing activities	<u>1,251</u>	<u>(25,077)</u>
Financing Activities:		
Proceeds from exercise of stock options and employee stock purchase plan	251	229
Proceeds from private placement financing, net of issuance costs	—	25,950
Proceeds from term loan, line of credit and asset financings	—	1,000
Principal payments on capital lease and term loan obligations	(585)	(381)
Net cash provided by (used in) financing activities	<u>(334)</u>	<u>26,798</u>
Net decrease in cash and cash equivalents	(1,939)	(124)
Cash and cash equivalents at beginning of period	20,291	15,491
Cash and cash equivalents at end of period	<u>\$ 18,352</u>	<u>\$ 15,367</u>
Supplemental Cash Flow Information:		
Equipment acquired in capital lease agreements	\$ 238	\$ —
Cash paid during the period for interest	<u>\$ 95</u>	<u>\$ 54</u>

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 provider of health, beauty, vision and pharmacy products. We offer health, beauty, sexual well-being, household and other non-prescription products and prescription medications through our website at *www.drugstore.com*. We also offer prestige beauty products through our website located at *www.beauty.com* (which is also accessible through the drugstore.com website); contact lenses through our wholly owned subsidiary International Vision Direct Corp. and its subsidiaries, collectively referred to as Vision Direct, through websites located at *www.visiondirect.com*, *www.lensmart.com* and *www.lensquest.com* (which are also accessible through the drugstore.com website); and customized nutritional supplement programs through our wholly owned subsidiary, Custom Nutrition Services, Inc. (CNS). Our products are also available toll-free by telephone at 1-800-DRUGSTORE and 1-800-VISIONDIRECT. Under the terms of an agreement with Rite Aid Corporation, or Rite Aid, customers are also able to order refill prescriptions for pickup at any Rite Aid store. We manage our business in four segments: over-the-counter (OTC), mail-order pharmacy, local pick-up pharmacy, and vision.

2. Basis of Presentation and Principles of Consolidation

The accompanying consolidated financial statements have been prepared in conformity with United States generally accepted accounting principles (GAAP) and the rules and regulations of the Securities and Exchange Commission (SEC). These consolidated financial statements have been prepared pursuant to the rules and regulations of the 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 the results that may be expected for the fiscal year ending December 31, 2006 or any other interim period, due to seasonal and other factors. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been omitted in accordance with the rules and regulations of the SEC. These consolidated financial statements should be read 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 1, 2006.

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

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.

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. Actual results could differ from our estimates, and these estimates could be material.

4. Net Loss Per Share

Net loss per share is computed using the weighted average number of shares of common stock outstanding. Shares associated with stock options, warrants, and our employee stock purchase plan are not included in the calculation of diluted net loss per share as they are antidilutive.

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The following table sets forth the computation of basic and diluted net loss per share for the periods indicated:

	Three Months Ended	
	April 2, 2006	April 3, 2005
	(in thousands, except share and per share data)	
Numerator:		
Net loss	\$ (5,293)	\$ (4,994)
Denominator:		
Weighted average shares outstanding used in computation of basic and diluted net loss per share	92,969,650	85,487,764
Basic and diluted net loss per share	\$ (0.06)	\$ (0.06)

At April 2, 2006 and April 3, 2005 there were 17,319,708 and 16,039,961 shares, respectively, of common stock subject to outstanding stock options and 615,000 shares of common stock subject to warrants in each period that were excluded from the computation of diluted net loss per share as their effect was antidilutive. If we had reported net income, the calculation of these per share amounts would have included the dilutive effect of these common stock equivalents using the treasury stock method.

5. Stock-Based Compensation

Stock-Based Benefit Plans

1998 Stock Plan - Under the terms of our 1998 Stock Plan, as amended (1998 Stock Plan), our board of directors may grant incentive and nonqualified stock options to employees, officers, directors, agents, consultants and independent contractors of drugstore.com. Options to purchase 15,764,528 shares of common stock were outstanding under the 1998 Stock Plan at January 1, 2006 and, during the three months ended April 2, 2006, options to purchase 2,124,715 common shares were granted in connection with our annual employee stock option grants. Options under this plan generally vest as follows: 20% of the shares vest during the first six months and the remaining 80% vest quarterly over the subsequent 42 months. Option grants are approved by the board of directors, generally have exercise prices equal to the fair market value of the common stock on the date of grant and expire 10 years from the date of grant.

1999 Employee Stock Purchase Plan - Under the terms of our 1999 Employee Stock Purchase Plan, as amended (1999 ESPP), eligible employees may purchase common stock for a purchase price equal to 85% of the fair market value of our common stock on the first or last day, whichever is less, of the applicable six-month purchase period. During the three months ended April 2, 2006, employees purchased 51,420 shares of our common stock under the 1999 ESPP in exchange for approximately \$141,000, and during the three months ended April 3, 2005, employees purchased 71,179 shares of common stock under the 1999 ESPP in exchange for approximately \$157,000.

Adoption of FASB Statement No. 123 (revised 2004)

Prior to January 2, 2006, we accounted for the 1998 Stock Plan and the 1999 ESPP under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related Interpretations, as permitted by Financial Accounting Standards Board (FASB) Statement No. 123, *Accounting for Stock-based Compensation* (FAS 123). Under APB 25, no compensation expense was recognized when the exercise price of employee stock options equaled the fair value of the underlying stock on the date of grant. Deferred stock-based compensation was recorded for those situations where the exercise price of an option was lower than the fair value for financial reporting purposes of the underlying common stock on the date of grant. Deferred stock-based compensation totaling \$2.0 million was being amortized over the vesting period of the underlying options using the multiple-option approach and was reversed against stockholders' equity on January 2, 2006. Prior year amounts have been reclassified to conform to the current year presentation.

Effective January 2, 2006, we adopted the fair value recognition provisions of FASB Statement No. 123 (revised 2004), *Share-Based Payment* (FAS 123R), using the modified-prospective-transition method, which requires measurement of compensation cost for all stock-based awards at fair value on the date of grant and recognition of compensation over the service period for awards expected to vest. Under the modified-prospective-transition method, compensation cost recognized in 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 2, 2006, which is based on the grant date fair value estimated in accordance with the original provisions of FAS 123, recognized over the vesting period of the underlying options using

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the multiple-option approach, (b) compensation cost for all share-based payments granted after January 1, 2006, which is based on the grant-date fair value estimated in accordance with the provisions of FAS 123R, recognized over the requisite service period of the award on a straight-line basis, and (c) compensation cost for shares issued under the 1999 ESPP, which is based on the fair value estimated in accordance with the provisions of FAS 123R and is not considered material to our overall financial statements. In accordance with the modified-prospective-transition method, results for the three months ended April 3, 2005 have not been restated to reflect, and do not include, the impact of FAS 123R.

Determining Fair Value

We calculate the fair value of our stock options granted to employees using the Black-Scholes option pricing model using the single option award approach. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. The following weighted-average assumptions were used for the three months ended April 2, 2006 and April 3, 2005:

	Three Months Ended	
	April 2, 2006	April 3, 2005
Expected volatility	80%	83%
Expected term (in years)	6.0	3.2
Risk-free interest rate	4.1%	3.9%
Expected dividend	0%	0%
Weighted-average fair value	\$ 2.11	\$ 1.52

Our computation of expected volatility for the first quarter of 2006 is based on our historical volatility, adjusted for changes in capital structure and corporate changes, information available that may indicate future volatility, and observable mean reversion tendencies of historical volatility. Prior to 2006, our computation of expected volatility was based on our historical volatility. Our expected life in 2006 was calculated using the simplified method outlined by SEC Staff Accounting Bulletin No. 107 (SAB 107). Under this method, our expected term is equal to the sum of the weighted average vesting term plus the original contractual term divided by two, which results in a six-year expected term. Prior to 2006, our computation of expected life was based on vesting schedules and historical experience of options exercised. We base the risk-free interest rate on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term. Where the expected term of our stock-based awards do not correspond with the terms for which interest rates are quoted, we average the periods to determine the rate from the available term maturities. A dividend yield of 0% was considered appropriate as we have not issued and do not anticipate issuing any dividends in the near future. When estimating forfeitures, we considered historical voluntary termination behavior, in addition to analyzing actual option forfeitures. In conjunction with this analysis, we identified distinct subgroups: non-management employees, management employees, our chief executive officer, board members, and other non-employees. Our forfeiture rate is based on the weighted average termination behavior of our non-management and management employee subgroups, which is approximately 30%, and assumes a rate of 0% for our chief executive officer, board members, and non-employees. Prior to the adoption of FAS 123R, we recognized the impact of forfeitures when they occurred.

Stock Compensation Expense

As a result of adopting FAS 123R on January 2, 2006, we recognized stock-based compensation totaling \$1.7 million for the three months ended April 2, 2006. Our incremental stock-based compensation expense resulting from the adoption of FAS 123R totaled \$1.5 million and increased our basic and diluted net loss per share by \$0.02, which includes a reduction of stock-based compensation of \$248,000 that would have been recognized prior to the adoption for options granted with an exercise price below the market value on the date of grant. As required by FAS 123R, management made an estimate of expected forfeitures and is recognizing compensation costs only for those equity awards expected to vest. Prior to January 2, 2006, we recognized stock-based compensation under the provisions of APB 25 and FAS 123 for options granted with exercise prices below market value on the date of grant, options and warrants issued to non-employees for services, and modifications to existing option grants. Such compensation expense totaled \$848,000 for the three months ended April 3, 2005.

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The following table summarizes stock-based compensation by operating function recorded in the Statement of Operations:

	Three Months Ended	
	April 2, 2006	April 3, 2005
Fulfillment and order processing	\$ 221	\$ —
Marketing and sales	324	143
Technology and content	272	4
General and administrative	886	701
Total	<u>\$ 1,703</u>	<u>\$ 848</u>

As of April 2, 2006, the total compensation cost related to unvested options granted to employees under our 1998 Stock Plan totaled \$10.3 million, net of estimated forfeitures of approximately \$4.9 million. This cost will be amortized on a straight-line basis over a weighted-average period of 3.5 years and will be adjusted for subsequent changes in estimated forfeitures.

Stock Option Activity

The following table summarizes activity under our 1998 Stock Plan:

	Number of Shares Subject to Options	Weighted- Average Exercise Price per Share	Weighted- Average Remaining Contractual Term	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2006	15,764,528	\$ 3.84		
Options granted	2,124,715	\$ 2.97		
Options exercised	(54,814)	\$ 2.12		
Options forfeited	(514,721)	\$ 3.85		
Outstanding at April 2, 2006	<u>17,319,708</u>	\$ 3.74	8.01	\$ 5,123
Vested and expected to vest at April 2, 2006	<u>13,010,154</u>	\$ 3.97	<u>0.61</u>	<u>\$ 4,619</u>
Exercisable at April 2, 2006	<u>7,215,190</u>	\$ 4.67	<u>6.70</u>	<u>\$ 3,829</u>

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the market price of our common stock for the 12.3 million shares subject to options that were in-the-money at April 2, 2006 (i.e., with an exercise price of \$3.00 or less).

Pro-forma Disclosures

The following table illustrates the effect on net loss and net loss per share had we applied the fair value recognition provisions of FAS 123 to options granted under our 1998 Stock Plan and our 1999 ESPP for all periods presented prior to January 2, 2006 (in thousands, except share and per share data):

	Three Months Ended April 3, 2005
Net loss, as reported	\$ (4,994)
Add: Stock-based compensation, as reported	848
Deduct: Total stock-based compensation determined using the fair value method under FAS 123 for all awards	(2,220)
Pro forma net loss	<u>\$ (6,366)</u>
Basic and diluted net loss per share – as reported	<u>\$ (0.06)</u>
Basic and diluted net loss per share – pro forma	<u>\$ (0.07)</u>

Disclosure for the three months ended April 2, 2006 is not presented because stock-based payments were accounted for under FAS 123R's fair-value method during this period.

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6. Line of Credit

In March 2006, we entered into an amended and restated loan and security agreement with our existing bank. This agreement includes a revolving line of credit allowing for borrowings of up to \$7.5 million, which accrue interest at the prime rate. The revolving line of credit has a maturity date of one year from the date of advance. The agreement allows for the conversion of up to \$2.5 million of the outstanding balance into a term loan within 60 days of maturity. No amounts have been borrowed on the line of credit as of April 2, 2006.

7. Commitments and Contingencies

Legal Proceedings

Class Action Laddering Litigation. On and after July 6, 2001, eight stockholder class action lawsuits were filed in the United States District Court for the Southern District of New York naming 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 complaints against drugstore.com have been consolidated into a single action and a Consolidated Amended Complaint, which is now the operative complaint, was filed on April 19, 2002. The suit purports to be a class action 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 for failure 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 former officers and directors. On July 15, 2002, we moved to dismiss all claims against us and the Individual Defendants. On October 9, 2002, the Court dismissed the Individual Defendants from the case without prejudice based on stipulations of dismissal filed by the plaintiffs and the Individual Defendants. On February 19, 2003, the Court denied the motion to dismiss the complaint against drugstore.com. On October 13, 2004, the Court certified a class in nine of the approximately 300 other nearly identical actions and noted that the decision is intended to provide strong guidance to all parties regarding class certification in the remaining cases. The underwriter defendants sought leave to appeal the class certification decision and the United States Court of Appeals for the Second Circuit has accepted the appeal. Plaintiffs have not yet moved to certify a class in our case.

We have approved a settlement agreement and related agreements, which set forth the terms of a settlement between drugstore.com, the plaintiff class and the vast majority of the other issuer defendants or, in the case of bankrupt issuers, their directors and officers. Among other provisions, the settlement agreement provides for a release of drugstore.com and the Individual Defendants for the conduct alleged in the action to be wrongful. We would agree to undertake certain responsibilities, including agreeing to assign away, not assert, or release certain potential claims we may have against our underwriters. The settlement agreement also provides a guaranteed recovery of \$1 billion to the plaintiffs for the cases relating to all of the approximately 300 issuers. To the extent that the underwriter defendants settle all of the cases for at least \$1 billion, no payment will be required under the issuers' settlement agreement. On April 20, 2006, JPMorgan Chase (one of the underwriter defendants) and the plaintiffs reached a preliminary agreement for a settlement for \$425 million. The JPMorgan Chase settlement has not yet been approved by the Court. If it is finally approved, however, then the maximum amount for which the issuers' insurers will be potentially liable is \$575 million. To the extent that the underwriter defendants settle for less than \$1 billion, the issuers are required to make up the difference. We anticipate that any potential financial obligation of drugstore.com to the plaintiffs pursuant to the terms of the settlement agreement and related agreements will be covered by existing insurance, and we have already satisfied our deductible. We are currently not aware of any material limitations from our insurance carriers on the expected recovery of any potential financial obligation to the plaintiffs. Our carriers are solvent and we are not aware of any uncertainties as to the legal sufficiency of an insurance claim with respect to any recovery by the plaintiffs. Therefore, we do not expect that the settlement will involve any payment by us. If material limitations on the expected recovery of any potential financial obligation to the plaintiffs from our insurance carriers should arise, our maximum financial obligation to plaintiffs pursuant to the settlement agreement would be less than \$3.4 million. However, if the JPMorgan Chase settlement is finally approved, our maximum financial obligation to the plaintiffs pursuant to the settlement agreement would be less than \$2 million.

On February 15, 2005, the Court granted preliminary approval of the settlement agreement, subject to certain modifications consistent with its opinion. These modifications have been made. On March 20, 2006, the underwriter defendants submitted objections to the settlement to the Court. The Court held a hearing regarding these and other objections to the settlement at a fairness hearing on

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April 24, 2006, but has not yet issued a ruling. There is no assurance that the Court will grant final approval to the settlement. We are unable to estimate the potential damages that might be awarded if the settlement were not approved, 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.

State Sales Tax Claims . In early 2002, we received an arbitrary assessment notice from the state of New Jersey for past sales tax due from fiscal years 2000 and 2001, based upon its best estimate of sales revenue numbers during those periods. In December 2002, we received a revised assessment from the state of New Jersey for 2000 and 2001 in the amount of \$221,626 in tax, plus penalties in the amount of \$11,081 and interest that continues to accrue. We do not currently collect and do not believe that we are required to collect New Jersey sales tax. In March 2003, we filed an appeal of the revised assessment with the Tax Court of New Jersey, based on the fact that the state of New Jersey is pursuing its claim specifically against one of our consolidated subsidiaries that is not a retailing entity in that state. The appeal is pending and trial is scheduled for November 2006. Due to the uncertainty of the appeal, no amounts have been recorded in the accompanying financial statements with respect to the sales tax alleged to be due. If we are unsuccessful in our appeal, the state of New Jersey may expand its assessment to include other years for which we did not collect sales tax. No amounts have been accrued for this matter as our liability, if any, cannot be reasonably estimated. However, the ultimate outcome of this matter could result in substantial tax liabilities for our past sales and have a material adverse effect on our financial position and results of operations.

Stockholder Derivative Action . On August 13, 2004, two stockholder derivative actions were filed by plaintiffs Gerald Rusk and George Zimmer in the Superior Court of the state of Washington, King County, against certain of our present and former officers and directors. The derivative plaintiffs allege breach of fiduciary duty based on the failure to prevent the disclosure violations alleged in the securities complaints that were dismissed in October, 2005. Plaintiffs also allege abuse of control, gross mismanagement, waste of corporate assets, and unjust enrichment. These actions seek damages from the defendants on behalf of drugstore.com, which is a nominal defendant in the actions. Plaintiffs allege that certain of the defendants breached their fiduciary duties by selling drugstore.com stock while in possession of material non-public information. Plaintiffs filed a consolidated amended complaint on July 29, 2005. The Outside Director Defendants filed a Motion to Dismiss on March 31, 2006. Plaintiffs' opposition brief is due May 15, 2006 the Outside Directors' reply brief is due June 16, 2006 and Oral Argument will be held on July 14, 2006.

Although the stockholder derivative complaints do not seek financial relief directly from drugstore.com, the litigation could have financial consequences for us through, for example, the attorneys' fees we incur and advances to the defendants and, if appropriate under the circumstances, indemnification of the defendants. No amounts have been accrued for this matter, as our liability, if any, cannot be reasonably estimated. 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.

8. Segment Information

We have four reporting segments: over-the-counter (OTC), mail-order pharmacy, local pick-up pharmacy, and vision. The OTC segment is comprised of the sales and related costs of selling all non-prescription products through our websites, customized nutritional supplement programs through CNS, and net sales of consignment products. Before December 31, 2005, all sales of customized vitamins through CNS were recognized on a gross basis, net of promotional discounts, cancellations, rebates and returns allowances. On December 31, 2005, we entered into a fulfillment agreement with Weil Lifestyle, LLC (Weil). Under the terms of the new agreement, we recognize on a net basis the revenue associated with the fulfillment of customized vitamins sold through Weil. Until November 9, 2005, the OTC segment also included wholesale OTC net sales and fulfillment fees generated through our agreement with Amazon.com, Inc., which we terminated effective November 9, 2005. The mail-order pharmacy segment is comprised of sales and the related costs of selling pharmaceuticals through the drugstore.com website for mail-order delivery. The local pick-up pharmacy segment is comprised of sales and the related costs of selling pharmaceuticals through the drugstore.com website and the RiteAid.com website for pick-up at a local Rite Aid store. Our vision segment is comprised of sales and the related costs of selling contact lenses through Vision Direct. We manage 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, credit card fees, and royalty costs that are variable based on sales volume).

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The information presented below for these segments is information used by our chief operating decision maker in evaluating operating performance.

	Three Months Ended	
	April 2, 2006	April 3, 2005
Over-the-Counter (OTC):		
Net sales	\$ 49,006	\$44,509
Cost of sales	34,663	32,515
Variable order costs (a)	4,328	4,717
Contribution margin (b)	<u>\$ 10,015</u>	<u>\$ 7,277</u>
Mail-Order Pharmacy:		
Net sales	\$ 18,300	\$17,953
Cost of sales	15,845	15,521
Variable order costs (a)	1,602	1,750
Contribution margin (b)	<u>\$ 853</u>	<u>\$ 682</u>
Local Pick-Up Pharmacy:		
Net sales (c)	\$ 24,213	\$24,976
Cost of sales	21,588	21,918
Variable order costs (a)	992	1,054
Contribution margin (b)	<u>\$ 1,633</u>	<u>\$ 2,004</u>
Vision:		
Net sales	\$ 12,590	\$12,135
Cost of sales	9,793	9,382
Variable order costs (a)	661	726
Contribution margin (b)	<u>\$ 2,136</u>	<u>\$ 2,027</u>
Consolidated:		
Net sales	\$104,109	\$99,573
Cost of sales	81,889	79,336
Variable order costs (a)	7,583	8,247
Consolidated contribution margin (b)	<u>\$ 14,637</u>	<u>\$11,990</u>
Less:		
Fixed fulfillment and order processing (d)	\$ 2,613	\$ 2,673
Marketing and sales (e)	8,958	6,328
Technology and content	3,942	2,932
General and administrative	4,294	4,429
Amortization of intangible assets	530	801
Operating loss	<u>\$ (5,700)</u>	<u>\$ (5,173)</u>

- (a) These amounts include all variable costs of fulfillment and order processing, including labor, packaging supplies, and credit card fees, and royalty costs that are variable based on sales volume. These amounts exclude depreciation, stock-based compensation and fixed overhead costs.
- (b) Contribution margin represents a measure of how well each segment is contributing to our operating goals. It is calculated as net sales less the direct cost of goods sold and the incremental (variable) fulfillment and order processing costs of delivering orders to our customers and royalty costs.
- (c) Net sales in our local pick-up pharmacy segment include co-payments totaling \$5.5 million for each of the three-month periods ended April 2, 2006 and April 3, 2005.
- (d) These amounts include all fixed costs of fulfillment and order processing that are not discernable by business segment.
- (e) These amounts exclude royalty expenses that are included in variable costs.

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

The following discussion and analysis should be read 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 1, 2006.

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. 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. Words such as "targets," "expects," "believes," "anticipates," "intends," "may," "will," "plan," "forecast," "continue," "remain," "would," "should," and similar expressions, are intended to identify forward-looking statements. 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 lead to such differences could include, among other things: effects of changes in the economy, changes in consumer spending, fluctuations in the stock market, changes affecting the Internet, online retailing and advertising, difficulties establishing our brand and building a critical mass of customers, the unpredictability of future revenues and expenses and potential fluctuations in revenues and operating results, risks related to business combinations and strategic alliances, possible tax liabilities relating to the collection of sales tax, consumer trends, the level of competition, seasonality, the timing and success of expansion efforts, changes in senior management, risks related to systems interruptions, possible governmental regulation and the ability to manage a growing business. These factors described in this paragraph and other 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 1, 2006. A forward-looking statement should not be relied upon as representing our views as of any date other than the date on which we made the statement. We do not intend to update any forward-looking statement after the date on which we make it.

Overview

drugstore.com, inc. is a leading online provider of health, beauty, vision and pharmacy products. We believe that we offer a better way for consumers to shop for these products through our web stores, including those located on the Internet at www.drugstore.com, www.beauty.com, www.visiondirect.com, www.lensmart.com and www.lensquest.com.

Business Segments; Growth Strategies. We operate our business in four business segments: over-the-counter, or OTC, mail-order pharmacy, local pick-up pharmacy, and vision.

- *Over-the-counter (OTC)* . Our OTC segment includes all non-prescription products sold online or over the telephone through our web stores at www.drugstore.com, www.beauty.com, www.visiondirect.com, www.lensmart.com and www.lensquest.com, and customized nutritional supplements sold through our subsidiary Custom Nutrition Services, Inc., or CNS. Before December 31, 2005, all sales of customized vitamins through CNS were recognized on a gross basis, net of promotional discounts, cancellations, rebates and returns allowances. On December 31, 2005, the company entered into a fulfillment agreement with Weil Lifestyle, LLC, or Weil. Under the terms of the new agreement, which replaced our previous agreement with Weil, we recognize on a net basis the revenue associated with the fulfillment of customized vitamins sold through Weil. Until November 9, 2005, our OTC segment also included product revenues and fulfillment fees received under our wholesale OTC fulfillment agreement with Amazon.com, Inc., under which we acted as a nonexclusive wholesaler and fulfillment provider for certain OTC products sold through the Health & Personal Care store on the Amazon.com website. Effective November 9, 2005, we terminated this agreement. The change in the terms of our agreement with Weil, which led us to recognize revenue on a net basis for the substantial majority of our first-quarter CNS revenue, and the termination of the Amazon.com wholesale OTC agreement make it more difficult to provide a meaningful year-over-year comparison for the first quarter. Accordingly, in this quarterly report we refer to our "core OTC" net sales, which exclude wholesale OTC net sales and CNS net sales of \$0 and \$638,000 in the first quarter of 2006, and \$2.5 million and \$2.0 million in the first quarter of 2005. We source our OTC products from various manufacturers and distributors. We believe that continued growth in this segment will depend on our ability to offer customers a superior shopping experience and service, including providing a broad selection of basic necessity items and hard-to-find specialty items, which encourages customers to return to our websites and make repeat, replenishment, and impulse purchases. In 2006, we continue to focus on improving website conversion, refining our personalization efforts for our website and promotional e-mails, and maximizing the profitability of each order.
- *Mail-Order Pharmacy* . Our mail-order pharmacy segment includes prescription drugs and supplies, other than prescription contact lenses, sold online or over the telephone through the www.drugstore.com web store and delivered to customers through our mail-order facility. We procure our prescription inventory through Rite Aid Corporation as part of our ongoing

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relationship. We market to and serve both cash-paying and insurance-covered individuals, and we also serve as a third-party provider of mail-order prescription fulfillment services for pharmacy benefit management companies, or PBMs, and third-party benefits companies. In this segment, we focus our marketing efforts on establishing broader relationships with PBMs and maximizing growth in our cash prescription business. We are also exploring additional advertising relationships with pharmaceutical manufacturers and advertising agencies that represent pharmaceutical manufacturers, to monetize the more than one million unique visitors per month to our online pharmacy site. We anticipate that continued growth in this segment in 2006 will substantially depend on our ability to grow prescription volumes through these efforts and our ability to broaden our source of revenue. However, we anticipate that our decision not to participate in the low-margin Medicare Part D prescription drug benefit program offered by the U.S. government may negatively impact our growth.

- *Local Pick-Up Pharmacy* . Our local pick-up pharmacy business segment includes prescription refills sold online or over the telephone through the *www.drugstore.com* web store or the *www.RiteAid.com* web store (which is powered by the *www.drugstore.com* web store) and picked up by customers at Rite Aid stores. In this segment, Rite Aid acts as our fulfillment partner. Our success in this segment depends on our ability to leverage our relationship with Rite Aid through its marketing media, including Rite Aid store receipts, weekly Rite Aid advertising circulars and e-mail refill reminders. In 2006, we anticipate that net sales in the local pick-up pharmacy segment will not be a source of growth, as we focus the majority of our marketing efforts on our core OTC and mail-order pharmacy segments.
- *Vision* . The vision segment includes contact lenses sold through our wholly owned subsidiary International Vision Direct Corp. and its subsidiaries, collectively referred to as Vision Direct, through websites located at *www.visiondirect.com*, *www.lensmart.com* and *www.lensquest.com* . We purchase our contact lens inventory directly from various manufacturers and other distributors. In 2006, we are focusing on a strategy of balancing customer acquisition with net margin in order to maximize our profits, rather than focusing exclusively on growth.

Revenues . We generate revenue primarily from product sales and shipping fees. For the three-month period ended April 2, 2006, we reported consolidated total net sales of \$104.1 million, which reflected a \$4.5 million, or 5%, increase over the three-month period ended April 3, 2005. Our net sales growth was driven by a 4% year-over-year increase in our total order volume, to over 1.3 million orders, and our average net sales per order remained consistent at \$77. Our revenues benefited from strong growth in our OTC segment, which grew by 10% over the first quarter of 2005; our core OTC net sales and order volume (excluding wholesale and CNS) grew by 21% and 23%, respectively. Our net sales in our vision segment increased year-over-year by \$455,000, or 4%, and our net sales in our mail-order pharmacy segment increased by \$347,000, or 2%. These increases were partially offset by a year-over-year decrease in local pick-up pharmacy net sales of \$763,000, or 3%.

Expenses . Our operating expenses, including cost of goods sold, increased slightly as a percentage of net sales to 106% in the three-month period ended April 2, 2006, from 105% in the three-month period ended April 3, 2005. The increase resulted from an increase in marketing expenses, primarily from our brand campaign costs of \$1.8 million, or 2% of net sales, incurred in the first quarter of 2006, and increased technology costs. Despite the increase in operating expenses, our cost of goods sold decreased as a percentage of net sales year-over-year, reflecting both a favorable shift in our product mix and significant improvement in OTC margins due to the success of operating initiatives undertaken to improve OTC profitability. In addition, our fulfillment and general and administrative costs declined year-over-year. During the first quarter of 2006, we adopted the provisions of Financial Accounting Standards Board Statement No. 123 (revised 2004), *Share-Based Payment* , or FAS 123R, which requires the recognition of the fair value of stock-based compensation. Under the fair value recognition provisions of FAS 123R, stock-based compensation cost is estimated at the grant date based on the fair value of the awards expected to vest and recognized as expense ratably over the requisite service period of the award. As a result of the adoption of FAS 123R, we recognized \$855,000, or 1% of net sales, of additional stock-based compensation in the first quarter of 2006, compared to the first quarter of 2005.

Net Loss; Cash Position . Our net loss for the three-month period ended April 2, 2006 increased by 6%, or \$299,000, to \$5.3 million, compared to \$5.0 million for the three-month period ended April 3, 2005. We ended the first quarter of 2006 with \$41.9 million in cash, cash equivalents and marketable securities, compared to \$46.5 million at January 1, 2006 and \$57.5 million at April 3, 2005. This balance reflects the use in the first quarter of 2006 of \$2.9 million to fund operating activities, \$1.4 million for capital expenditures, and \$585,000 to repay debt obligations, offset by proceeds received of \$251,000 from the exercise of employee stock options and purchases under our employee stock purchase plan.

Significant Accounting Judgments

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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

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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. Based on this definition, we have identified the significant accounting policies and judgments addressed below. We also have other key accounting policies that involve the use of estimates, judgments and assumptions that are significant to understanding our results. Additional information about our significant accounting policies is 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 1, 2006. Although we believe that our estimates, assumptions and judgments are reasonable, they are based upon 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.

Revenue Recognition

We recognize revenues in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition*.

Revenues from sales of OTC (other than Weil-related CNS sales, as described below), mail-order pharmacy, and vision products are recorded net of promotional discounts, cancellations, rebates and returns allowances. Revenue is recognized when the following revenue recognition criteria are met: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the selling price or fee earned is fixed or determinable; and (4) collection of the resulting receivable is reasonably assured. We generally require payment by credit card at the point of sale. Return allowances, which reduce product sales by our estimate of expected product returns, are estimated using historical experience. Historically, product returns, and differences between our estimates and actual returns, have not been significant.

Revenues from sales of customized vitamins sold through our fulfillment agreement with Weil are recognized when products are shipped and title passes to the customer. In accordance with Emerging Issues Task Force Issue No. 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*, or EITF 99-19, we record revenues generated by the Weil agreement in our OTC segment on a net basis, because we act as an agent, based on the fact that we earn a fixed dollar amount per customer transaction regardless of the amount billed to the customer and we do not bear general inventory risk associated with these sales. Non-Weil customized vitamin sales are recognized on a gross basis, net of promotional discounts, cancellations, rebates and returns allowances. (Before we entered into the new fulfillment agreement with Weil on December 31, 2005, we also recognized Weil customized vitamin sales on a gross basis, net of promotional discounts, cancellations, rebates and returns allowances.) Net sales in our OTC segment also include consignment service fees earned under our agreement with General Nutrition Corporation, or GNC, which are also recorded on a net basis, because we do not take title to the inventory and do not establish pricing.

Revenues from sales of OTC products ordered through the Amazon.com website and fulfilled by drugstore.com were recognized when we shipped the products from our distribution center. In accordance with EITF 99-19, we recorded fulfillment fees and revenues generated by the Amazon.com agreement in our OTC segment on a gross basis, because we believe we acted as a principal, based on the fact that we bore general inventory risk associated with these sales. Effective November 9, 2005, we terminated our agreement with Amazon.com. Neither party has any material obligations following termination.

Revenues from sales of prescription products ordered online or by telephone through the drugstore.com web store or the RiteAid.com web store (which is powered by the drugstore.com web store) for pick-up at a Rite Aid store, including co-payments received and collected on our behalf by Rite Aid, are recognized when the customer picks up the product. In these circumstances, we utilize Rite Aid as our fulfillment partner. In accordance with EITF 99-19, we record revenues in our local pick-up pharmacy segment on a gross basis, because we believe we act as a principal, based on the fact that, among other things, we bear both inventory risk and credit and collection risk associated with these sales.

For insured prescriptions in both our local pick-up and mail-order segments, the co-payment and the insurance reimbursement (which together make up the amount due to drugstore.com) constitute the full value of the prescription drug sale, and we receive this entire amount as cash. We therefore recognize the entire amount as revenue when the order is shipped to the customer (for mail order prescriptions) or picked up by the customer (for local pick-up prescriptions).

Periodically, we provide incentive offers to our customers to encourage purchases. Such offers include discounts on specific current purchases, or future rebates based upon a percentage of the current purchase, as well as other offers. Discounts, when accepted by our customers, are treated as a reduction to the sales price of the related transaction and are presented as a net amount in net sales. Rebates are treated as a reduction to the sales price based on estimated redemption rates. Redemption rates are estimated using our historical experience for similar offers. Historically, our redemption rates have not differed materially from our estimates, which are adjusted quarterly.

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Inventories

We value our inventories at the lower of cost (using the weighted-average cost method) or the current estimated market value. We regularly review inventory quantities on hand and adjust our inventories for shrinkage and slow-moving, damaged and expired inventory, which is recorded as the difference between the cost of the inventory and the estimated market value based on management's assumptions about future demand for the products we offer and market conditions. We use a variety of methods to reduce the quantity of slow-moving inventory, including reducing sales prices on our websites, negotiating returns to vendors, and liquidating inventory through third parties. If our estimates of future product demand or our assumptions about market conditions are inaccurate, we could understate or overstate the provision required for excess and obsolete inventory. Historically, inventory reserves have not differed materially from our estimates.

Goodwill and Other Intangible Assets

In accordance with Statement of Financial Accounting Standards No. 142, *Accounting for Goodwill and Other Intangibles*, or FAS 142, we do not amortize goodwill but instead test for impairment at least annually. We test for impairment at the beginning of the fourth quarter or whenever indicators of impairment occur. The first phase of the test screens for impairment. If impairment is determined, the second phase measures the amount of impairment by comparing the fair value of the applicable reporting unit to its carrying value. Fair value is determined using either a discounted cash flow methodology or methodology based on comparable market prices.

We review our indefinite-lived intangible assets, other than goodwill, for impairment when indicators of impairment occur and annually at the beginning of the fourth quarter. We compare the carrying value of the asset to its estimated fair value and record an impairment charge when the carrying value of the asset exceeds the estimated fair value.

In accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, or FAS 144, we review the carrying values of our amortized long-lived assets, including definite-lived intangible assets, whenever an indicator of impairment occurs. When facts and circumstances indicate that the carrying values of long-lived assets may be impaired, we perform an evaluation of recoverability. The determination of whether impairment exists is based on any excess of the carrying value over the expected future cash flows, as estimated through undiscounted cash flows, excluding interest charges. We measure any resulting impairment charge based on the difference between the carrying value of the asset and its fair value, as estimated through expected future discounted cash flows, discounted at a rate of return for an alternate investment.

If our estimates of revenue growth or future cash flows prove to be inaccurate, we may have a future impairment of goodwill, other intangible assets or long-lived assets.

Stock-Based Compensation

Effective January 2, 2006, we adopted the fair value recognition provisions of FAS 123R using the modified-prospective-transition method, which requires measurement of compensation cost for all stock-based awards at fair value on the date of grant and recognition of compensation over the service period for awards expected to vest. Under the modified-prospective-transition method, compensation cost recognized includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 2, 2006, which is based on the grant date fair value estimated in accordance with the original provisions of FAS 123, recognized over the vesting period of the underlying options using the multiple-option approach, (b) compensation cost for all share-based payments granted after January 1, 2006, which is based on the grant-date fair value estimated in accordance with the provisions of FAS 123R, recognized over the requisite service period of the award on a straight-line basis, and (c) compensation cost for shares issued under the 1999 ESPP, which is based on the fair value estimated in accordance with the provisions of FAS 123R and is not considered material to our overall financial statements. In accordance with the modified-prospective-transition method, results for the three months ended April 3, 2005 have not been restated to reflect, and do not include, the impact of FAS 123R.

We calculate the fair value of our stock options granted to employees using the Black-Scholes option pricing model using the single option award approach. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. Our computation of expected volatility is based on our historical volatility, adjusted for changes in capital structure and corporate changes, information available that may indicate future volatility, and observable mean reversion tendencies of historical volatility. Our computation of expected life is determined using the simplified method outlined by the SEC Staff Accounting Bulletin No. 107, or SAB 107. Under this method, our expected term is equal to the sum of the weighted average vesting term plus the original contractual term divided by two, which results in a six-year expected term. We base the risk-free interest rate on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term. Where the expected term of our stock-based awards do not correspond with the terms for which interest rates are quoted, we average the periods to determine the rate from the available term maturities. A dividend yield of 0% is considered appropriate as we have not issued and do not anticipate issuing any dividends in the near future. When estimating forfeitures, we consider historical voluntary termination

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behavior in addition to analyzing actual option forfeitures. In conjunction with this analysis, we identified distinct subgroups: non-management employees, management employees, our chief executive officer, board members, and other non-employees. Our forfeiture rate is based on the weighted average termination behavior of our non-management and management employee subgroups, which is approximately 30%, and assumes a rate of 0% for our chief executive officer, board members, and non-employees. Prior to the adoption of FAS 123R, we recognized the impact of forfeitures when they occurred.

Legal Proceedings

We are currently involved in various claims and legal proceedings. Periodically, we review the status of each significant matter and assess our potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be estimated, we accrue a liability for the estimated loss. Because of uncertainties related to these matters, accruals are based only on the best information available at the time. As additional information becomes available, we reassess the potential liability related to our pending claims and legal proceedings and may revise our estimates. Any such revisions in the estimates of the potential liabilities could have a material impact on our future results of operations and financial position. For a description of our material legal proceedings, see Note 7 of our consolidated financial statements, *Commitments and Contingencies*, included in Part I, Item 1 of this quarterly report.

Results of Operations

Net Sales

	Three Months Ended		
	April 2, 2006	% Change	April 3, 2005
	(in thousands, except per order data)		
Total net sales	\$104,109	4.6%	\$99,573
Total customer orders shipped	1,350	3.8%	1,301
Average net sales per order	\$ 77	—	\$ 77

Net sales includes gross revenues from sales of product and related shipping fees, net of discounts and provision for sales returns, third-party reimbursement and other allowances. Net sales also include consignment service fees earned from our arrangement with GNC, under which we do not take title to the inventory and cannot establish pricing. Consignment service fees are booked on a net basis and constitute approximately 1% of total net sales in each period presented. Included in net sales in 2005 are fulfillment fees and product revenue from our wholesale OTC fulfillment agreement with Amazon.com, which was terminated in November 2005. Also included in net sales in 2005 and 2006 are sales of customized nutritional supplements sold through CNS, which effective December 31, 2005, are now primarily recorded on a net basis under our fulfillment agreement with Weil. Orders are billed to the customer's credit card or, in the case of prescriptions covered by insurance, the co-payment is billed to the customer's credit card and the remainder of the prescription price is billed to insurance. Sales of pharmaceutical products covered by insurance are recorded as the sum of the amounts received from the customer and the third party. Sales made to Amazon.com under our wholesale OTC fulfillment agreement were billed directly to Amazon.com and recorded at the gross amount received from Amazon.com.

Total net sales increased in the three-month period ended April 2, 2006, compared to the three-month period ended April 3, 2005, as a result of a 4% increase in order volume, primarily driven by growth in our OTC segment. Revenues from repeat customers increased to 81% of net sales in the first quarter of 2006, compared to 77% in the first quarter of 2005. Average net revenue per order remained consistent at \$77 in both quarters. Compared to the first quarter of 2005, net sales in our OTC segment increased by \$4.5 million, or 10%, net sales in our vision segment increased by \$455,000, or 4%, and net sales in our mail-order pharmacy segment increased by \$347,000, or 2%. Net sales in our local pick-up pharmacy segment decreased by \$763,000, or 3%.

OTC Net Sales

	Three Months Ended		
	April 2, 2006	% Change	April 3, 2005
	(in thousands, except per order data)		
OTC net sales	\$49,006	10.1%	\$44,509
<i>Segmented net sales information:</i>			
% of total net sales from OTC	47.1%		44.7%
Average net sales per order	\$ 56	—	\$ 56

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Our net sales in the OTC segment increased by \$4.5 million to \$49.0 million in the three-month period ended April 2, 2006, compared to \$44.5 million in the three-month period ended April 3, 2005, as a result of increases in order volume. Excluding CNS net sales of \$683,000 in the first quarter of 2006 and \$2.0 million in the first quarter of 2005, and wholesale OTC net sales and fulfillment fees of \$2.5 million in the first quarter of 2005, our core OTC net sales increased by 21% year-over-year to \$48.3 million. The number of orders in our OTC segment grew by 10% to 870,000 in the first quarter of 2006, compared to 792,000 in the first quarter of 2005, and the average net sales per order remained consistent at \$56 in both periods. The number of customer orders includes new and repeat orders made through the drugstore.com website and the websites of our subsidiaries, orders generated through our fulfillment agreement with Weil, and orders generated through our wholesale OTC fulfillment agreement with Amazon.com. The increase in order volume was driven by our increasing active customer base and our continued efforts to improve customer retention and conversion. During the first quarter of 2006, we also performed a review of the pricing and profitability of each OTC product unit, or SKU, which did not result in material price changes in our OTC products individually, but in the aggregate is expected to favorably impact our gross margin.

Mail-Order Pharmacy Net Sales

	Three Months Ended		
	April 2, 2006	% Change	April 3, 2005
Mail-order pharmacy net sales	\$18,300	1.9%	\$17,953
<i>Segmented net sales information:</i>			
% of total net sales from mail-order pharmacy	17.6%		18.0%
Average net sales per order	\$ 155	9.9%	\$ 141

Our net sales in the mail-order pharmacy segment increased \$347,000 to \$18.3 million in three-month period ended April 2, 2006, compared to \$18.0 million in the three-month period ended April 3, 2005, as a result of year-over-year increases in the average net sales per order. The average net sales per order in this segment increased year-over-year as a result of an increase of approximately 5% in the average price per prescription resulting from higher pharmaceutical costs, and selling a larger proportion of higher-priced brand-name drugs. The number of orders in this segment decreased by 7% to 118,000 in the first quarter of 2006, compared to 127,000 in the first quarter of 2005, as a result of our decision not to participate in the low-margin Medicare Part D prescription drug benefit program offered by the U.S. government.

Local Pick-up Pharmacy Net Sales

	Three Months Ended		
	April 2, 2006	% Change	April 3, 2005
Local pick-up pharmacy net sales	\$24,213	(3.1%)	\$24,976
<i>Segmented net sales information:</i>			
% of total net sales from local pick-up pharmacy	23.3%		25.1%
Average net sales per order	\$ 112	4.7%	\$ 107

Our net sales in the local pick-up pharmacy segment decreased by \$763,000 to \$24.2 million in the three-month period ended April 2, 2006, compared to \$25.0 million in the three-month period ended April 3, 2005. This decrease in net sales reflects a 7% decrease in the number of orders in this segment, to 217,000 compared to 234,000 in the first quarter of 2005. Orders in this segment are driven by Rite Aid through its marketing media, including Rite Aid store receipts, weekly Rite Aid advertising circulars and e-mail refill reminders. The decrease in net sales was partially offset by a \$5 year-over-year increase in average net sales per order resulting from increases in the average price per prescription paid by the customer.

Vision Net Sales

	Three Months Ended		
	April 2, 2006	% Change	April 3, 2005
Vision net sales	\$12,590	3.7%	\$12,135
<i>Segmented net sales information:</i>			
% of total net sales from vision	12.1%		12.2%
Average net sales per order	\$ 87	6.1%	\$ 82

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Our net sales in the vision segment increased \$455,000 to \$12.6 million in the three-month period ended April 2, 2006, compared to \$12.1 million in the three-month period ended April 3, 2005, as a result of an increase in the average net sales per order, driven primarily from selling a greater proportion of higher-priced, newer-technology contact lenses, and to a lesser extent, an increase in the average number of items per order and price increases for certain SKUs (none of which were material). The number of orders in this segment decreased slightly to 145,000 in the first quarter of 2006, compared to 148,000 in the first quarter of 2005, as a result of a decrease in orders from new customers.

Customer Data.

Approximately 326,000 new customers placed orders during the three-month period ended April 2, 2006, increasing our total customer base to approximately 7.5 million customers since inception. Orders from repeat customers as a percentage of total orders increased to 74% in the first quarter of 2006, compared to 70% in the first quarter of 2005, as a result of an increase in our trailing 12-month active customer base. The year-over-year increase in orders from repeat customers as a percentage of total orders primarily resulted from improved customer retention and increased order frequency, and to a lesser extent, the inclusion of 84,000 wholesale OTC orders in 2005 compared to no orders in 2006. OTC wholesale orders and Weil-related orders (after December 31, 2005) are included in the number of total orders but are considered neither repeat nor new orders for calculating repeat orders as a percentage of total orders.

Cost of Sales

	Three Months Ended		
	April 2, 2006	% Change (\$ in thousands)	April 3, 2005
Cost of sales	\$81,889	3.2%	\$79,336
Percent of total net sales	78.7%		79.7%

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. Payments that we receive from vendors in connection with volume purchase or rebate allowances are netted against cost of sales.

Total cost of sales increased in absolute dollars in the three-month period ended April 2, 2006, compared to the three-month period ended April 3, 2005, as a result of growth in order volume and net sales. Cost of sales as a percentage of net sales decreased year-over-year primarily as a result of lower net shipping costs absorbed by us, a larger proportion of net sales in our OTC segment, which is our highest-margin segment, and improved margins resulting from our operational initiatives, including the review of pricing and profitability of our OTC SKUs.

Our revenues from shipping charges to customers are included in net sales and were \$3.4 million in the first quarter of 2006, compared to \$2.7 million in the first quarter of 2005. Outbound shipping costs are included in cost of sales and were \$5.5 million in the first quarter of 2006, compared to \$5.6 million in the first quarter of 2005. As part of our profitability initiatives, we continue to make pricing adjustments to our shipping policies to reduce our shipping costs. Most recently, we eliminated free 3-day shipping on orders of \$99 or more, added shipping surcharges for shipments to Alaska, Hawaii, U.S. Territories, and APO/FPO military addresses, increased the upgrade charge for 3-day shipping for customers who qualify for free ground shipping, added a weight-based shipping surcharge for orders over 20 pounds, and signed a new contract with one of our shipping carriers that we anticipate will provide lower rates. We expect to continue to subsidize a portion of customers' shipping costs for the foreseeable future, through free shipping options, as a strategy to attract and retain customers.

OTC Cost of Sales

	Three Months Ended		
	April 2, 2006	% Change (\$ in thousands)	April 3, 2005
OTC cost of sales	\$34,663	6.6%	\$32,515
<i>Segmented cost of sales information:</i>			
OTC cost of sales as a % of OTC net sales	70.7%		73.1%

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Cost of sales in our OTC segment increased in absolute dollars in the three-month period ended April 2, 2006, compared to the three-month period ended April 3, 2005, as a result of increased order volume. Cost of sales as a percentage of net sales in this segment decreased in the first quarter of 2006, compared to the first quarter of 2005, primarily as a result of lower per-order net shipping costs resulting from changes in our shipping policies, and to a lesser extent, improved margins from our operational initiatives, including the review of pricing and profitability of each of our OTC SKUs. As a result of these initiatives, our core OTC gross profit dollars (excluding wholesale OTC and CNS) increased \$3.1 million, or 29%, to \$13.6 million in the first quarter of 2006, compared to \$10.5 million in the first quarter of 2005.

Mail-Order Pharmacy Cost of Sales

	Three Months Ended		
	April 2, 2006	% Change (\$ in thousands)	April 3, 2005
Mail-order pharmacy cost of sales	\$15,845	2.1%	\$15,521
<i>Segmented cost of sales information:</i>			
Mail-order pharmacy cost of sales as a % of mail-order pharmacy net sales	86.6%		86.5%

Cost of sales in our mail-order pharmacy segment increased in absolute dollars but remained flat as a percentage of net sales in the three-month period ended April 2, 2006, compared to the three-month period ended April 3, 2005, as a result of increased per-order product costs and selling a higher proportion of higher-cost, lower-margin brand-name drugs.

Local Pick-up Pharmacy Cost of Sales

	Three Months Ended		
	April 2, 2006	% Change (\$ in thousands)	April 3, 2005
Local pick-up pharmacy cost of sales	\$21,588	(1.5%)	\$21,918
<i>Segmented cost of sales information:</i>			
Local pick-up cost of sales as a % of local pick-up pharmacy net sales	89.2%		87.8%

Cost of sales in our local pick-up pharmacy segment decreased in absolute dollars in the three-month period ended April 2, 2006, compared to the three-month period ended April 3, 2005, as a result of a 7% decrease in order volume. Cost of sales as a percentage of net sales in this segment increased in 2006, compared to 2005, as a result of increased per-order product costs and declining margins resulting from lower contractual reimbursement rates from insurance plans.

Vision Cost of Sales

	Three Months Ended		
	April 2, 2006	% Change (\$ in thousands)	April 3, 2005
Vision cost of sales	\$9,793	4.4%	\$9,382
<i>Segmented cost of sales information:</i>			
Vision cost of sales as a % of vision net sales	77.8%		77.3%

Cost of sales in our vision segment increased both in absolute dollars and as a percentage of net sales in the three-month period ended April 2, 2006, compared to the three-month period ended April 3, 2005, primarily as a result of a shift in product mix to sales of higher cost, newer technology contact lenses and increased promotional activity, offset by a slight decline in order volume.

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Fulfillment and Order Processing Expenses

	Three Months Ended		
	April 2, 2006	% Change (\$ in thousands)	April 3, 2005
Fulfillment and order processing expenses	\$10,177	(1.1%)	\$10,285
Percentage of net sales	9.8%		10.3%

Fulfillment and order processing expenses include expenses related to payroll and related expenses for personnel engaged in purchasing, fulfillment, distribution, and customer care activities (including warehouse personnel and pharmacists engaged in prescription verification activities), distribution center equipment and packaging supplies, per-unit fulfillment fees charged by Rite Aid for prescriptions ordered through the drugstore.com website and picked up at a Rite Aid store, credit card processing fees, and bad debt expenses. These expenses also include rent and depreciation related to equipment and fixtures in our distribution center and call center facilities. Variable fulfillment costs represent the incremental (variable) costs of fulfilling, processing and delivering the order that we believe are variable based on sales volume.

Fulfillment and order processing expenses for the three-month period ended April 2, 2006 were comprised of \$7.6 million of variable costs and \$2.6 million of fixed costs, compared to \$7.6 million of variable costs and \$2.7 million of fixed costs for the three-month period ended April 3, 2005. Variable fulfillment and order processing expenses remained flat year-over-year despite a 4% increase in order volume, as increased costs from the greater order volume were offset by lower per-order labor costs. Fixed fulfillment and order processing expenses also remained flat year-over-year primarily as a result of a decrease in depreciation expense of \$548,000 for assets fully depreciated during 2005, offset by stock-based compensation expense of \$221,000 resulting from the adoption of FAS 123R, and increased personnel costs of \$281,000. Fulfillment and order processing expenses as a percentage of net sales declined in the first quarter of 2006, compared to the first quarter of 2005, as greater order volumes resulted in improved utilization of our primary distribution center.

Marketing and Sales Expenses

	Three Months Ended		
	April 2, 2006	% Change (\$ in thousands)	April 3, 2005
Marketing and sales expenses	\$8,977	28.9%	\$6,963
Percentage of net sales	8.6%		7.0%

Marketing and sales expenses include advertising and marketing expenses, promotional expenditures and payroll and related expenses for personnel engaged in marketing and merchandising activities. Advertising expenses include various advertising contracts. In addition, marketing and sales expense include CNS-related royalties, which were reduced as a result of our new fulfillment agreement with Weil, of \$19,000 for the first quarter of 2006 and \$635,000 for the first quarter of 2005. Advertising and promotional costs in the first quarter of 2006 were \$6.7 million, compared to \$5.0 million in 2005.

Marketing and sales expenses increased both in absolute dollars and as a percentage of net sales for the three-month period ended April 2, 2006, compared to the three-month period ended April 3, 2005. The increase was primarily due to \$1.8 million in final costs related to our brand advertising campaign incurred in the first quarter of 2006, and an increase in stock-based compensation expense of \$181,000 resulting from the adoption of FAS 123R.

Technology and Content Expenses

	Three Months Ended		
	April 2, 2006	% Change (\$ in thousands)	April 3, 2005
Technology and content expenses	\$3,942	34.4%	\$2,932
Percentage of net sales	3.8%		2.9%

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

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Technology and content expenses for the three-month period ended April 2, 2006 increased both in absolute dollars and as a percentage of net sales, compared to the three-month period ended April 3, 2005. The increase resulted from increased depreciation expense of \$446,000 resulting from the acquisition of software and computer equipment related to enhancements to our IT infrastructure in 2005, an increase in stock-based compensation expense of \$268,000 resulting from the adoption of FAS 123R, and increased operational costs.

General and Administrative Expenses

	Three Months Ended		
	April 2, 2006	% Change (\$ in thousands)	April 3, 2005
General and administrative expenses	\$4,294	(3.0%)	\$4,429
Percentage of net sales	4.1%		4.4%

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

General and administrative expenses for the three-month period ended April 2, 2006 decreased both in absolute dollars and as a percentage of net sales, compared to the three-month period ended April 3, 2005. The decrease resulted primarily from reductions in corporate insurance costs and utility costs, offset by an increase of \$185,000 in stock-based compensation expense resulting from the adoption of FAS 123R, and increased professional fees. The decrease as a percentage of net sales resulted from our fixed corporate administrative costs being spread over more net sales.

Amortization of Intangible Assets

	Three Months Ended		
	April 2, 2006	% Change (\$ in thousands)	April 3, 2005
Amortization of intangible assets	\$ 530	(33.8%)	\$ 801

Amortization of intangible assets includes the amortization expense associated with assets acquired in connection with our acquisitions of CNS, Acumins, Inc., and Vision Direct, and assets acquired in connection with our agreements with Rite Aid and GNC, and other intangible assets, including a technology license agreement, domain names and trademarks.

The decrease in amortization expense for the three-month period ended April 2, 2006, compared to the three-month period ended April 3, 2005, resulted from certain intangible assets being fully amortized in 2005.

Interest Income and Expense

	Three Months Ended		
	April 2, 2006	% Change (\$ in thousands)	April 3, 2005
Interest income, net	\$ 407	127.4%	\$ 179

Interest income consists of earnings on our cash, cash equivalents and marketable securities, and interest expense consists primarily of interest associated with capital lease and debt obligations. Net interest income increased in the first quarter of 2006, compared to the first quarter of 2005, as a result of higher interest rates and higher weighted average cash, cash equivalents and marketable securities balance in first quarter of 2006 compared to 2005.

Income Taxes

There was no provision or benefit for income taxes for the three-month periods ended April 2, 2006 and April 3, 2005 due to our ongoing operating losses.

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Stock-Based Compensation

Effective January 2, 2006, we adopted the fair value recognition provisions of FAS 123R using the modified-prospective-transition method, which requires measurement of compensation cost for all stock-based awards at fair value on the date of grant and recognition of compensation over the service period for awards expected to vest. As a result of adopting FAS 123R on January 2, 2006, we recognized stock-based compensation totaling \$1.7 million for the three months ended April 2, 2006. Our incremental stock-based compensation expense resulting from the adoption of FAS 123R totaled \$1.5 million and increased our basic and diluted net loss per share by \$0.02, which includes a reduction of stock-based compensation of \$248,000 that would have been recognized prior to the adoption for options granted with an exercise below the market value on the date of grant. As required by FAS 123R, management made an estimate of expected forfeitures and we are recognizing compensation costs only for those equity awards expected to vest. Prior to January 2, 2006, we recognized stock-based compensation under the provisions of APB 25 and FAS 123 for options granted with exercise prices below market value on the date of grant, options and warrants issued to non-employees for services, and modifications to existing option grants. Such compensation expense totaled \$848,000 for the three months ended April 3, 2005. See Note 5 in our consolidated financial statements included in Part I, Item 1 of this quarterly report.

Off-Balance Sheet Transactions

We have not engaged in any off-balance sheet transactions.

Liquidity and Capital Resources

We have incurred net losses of \$742.6 million since inception. We believe that we may continue to incur net losses for at least the next year, and possibly longer. From our inception through April 2, 2006, we have financed our operations primarily through the sale of equity securities, including common and preferred stock, yielding net cash proceeds of \$413.9 million.

Discussion of Cash Flows

The following table provides information regarding our cash flows for the three-month periods ended April 2, 2006 and April 3, 2005.

	Three Months Ended		
	April 2, 2006	% Change (\$ in thousands)	April 3, 2005
Cash used in operating activities	\$(2,856)	54.80%	\$ (1,845)
Cash provided by (used in) investing activities	\$ 1,251	(104.99%)	\$(25,077)
Cash provided by (used in) financing activities	\$ (334)	(101.25%)	\$ 26,798
Net decrease in cash and cash equivalents	\$(1,939)	N/M	\$ (124)

Net cash used in operating activities for the three-month periods ended April 2, 2006 and April 3, 2005 primarily reflects net losses and changes in operating assets and liabilities, partially offset by non-cash expenses. Net cash used in operating activities increased in the first quarter of 2006, compared to the first quarter of 2005, primarily as a result of increased uses of other working capital partially offset by decreased investments in inventory.

Net cash provided by investing activities for the three-month period ended April 2, 2006 was primarily attributable to the sales and maturities of marketable securities, offset by the purchase of marketable securities and the acquisition of fixed assets. Net cash used in investing activities for the three-month period ended April 3, 2005 was primarily attributable to the purchase of marketable securities and acquisition of fixed assets, offset by the sale and maturity of marketable securities.

Net cash used in financing activities for the three-month period ended April 2, 2006 was attributable to the repayment of debt obligations, offset by proceeds received from the exercises of employee stock options and purchases under our employee stock purchase plan. Net cash provided by financing activities for the three-month period ended April 3, 2005 was attributable to \$26.0 million of net proceeds received from the sale of 10.0 million shares of our common stock, cash provided from exercises of employee stock options and purchases under our employee stock purchase plan, and borrowings under our revolving line of credit agreement with a bank, partially offset by payments on our debt obligations.

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, auction rate securities, corporate notes and government bonds, are considered short-term as they are available to fund current operations.

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Liquidity Sources, Requirements and Contractual Cash Requirements and Commitments

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.

Our primary source of cash is sales made through our websites, for which we collect cash from credit card settlements or insurance reimbursements. 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 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 year ended January 1, 2006.

In March 2006, we entered into an amended and restated loan and security agreement with our existing bank. This agreement includes a revolving line of credit allowing for borrowings of up to \$7.5 million, which accrue interest at the prime rate. The revolving line of credit has a maturity date of one year from the date of advance. The agreement allows for the conversion of up to \$2.5 million of the outstanding balance into a term loan within 60 days of maturity. No amounts have been borrowed on the line of credit as of April 2, 2006.

As of April 2, 2006, we did not have any future material noncancelable commitments to purchase goods or services.

We believe that our sources of cash will be sufficient to fund our operations and anticipated capital expenditures until we begin generating positive operating cash flow. 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 pursue business or technology acquisitions or decide to build a new distribution center or if our expectations regarding our operations and anticipated capital expenditures change). We have 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. 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.

Management Outlook

For the second quarter of fiscal year 2006, we are targeting net sales in the range of \$101.0 million to \$105.0 million and a net loss in the range of \$4.3 million to \$5.5 million.

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.

We have interest rate exposure arising from our financing facilities, which have variable rates. These variable interest rates are affected by changes in short-term interest rates. We manage our interest rate exposure by maintaining a conservative debt-to-equity ratio. We believe that the effect, if any, of reasonably possible near-term changes in interest rates on our financial position, results of operations and cash flows will not be material. Our financing facilities expose net earnings to changes in short-term interest rates because interest rates on the underlying obligations are variable. Borrowings outstanding under the interest-bearing financing facilities totaled \$2.2 million at April 2, 2006, and interest rates attributable to this outstanding balance ranged from 8% to 8.25% during the first quarter of 2006. 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. As of April 2, 2006, we had \$23.6 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.

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Item 4. Controls and Procedures

We have performed an evaluation under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, 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 and chief financial officer, concluded that, as of April 2, 2006, our disclosure controls and procedures were effective in ensuring that all material information required to be disclosed in reports filed or submitted by us under the Exchange Act is made known to them in a timely fashion.

During the quarter ended April 2, 2006, there were no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II—OTHER INFORMATION

Item 1. Legal Proceedings

See Note 7 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

The risk factor disclosure included under Item 1A of our Annual Report on Form 10-K for the fiscal year end January 1, 2006, filed with the Securities and Exchange Commission on March 17, 2006 (the “Form 10-K”) has not materially changed other than as set forth below.

We have a history of generating significant losses, and may never be profitable.

We have incurred net losses of \$742.6 million through April 2, 2006. To date, we have not become profitable, and we may never achieve profitability. We expect to continue to incur net losses for at least the next year, and possibly longer. As a result, our stock price may decline and investors may lose all or a part of their investment in our common stock.

The information above updates and should be read in conjunction with the discussion of our risk factors contained in Item 1A of the Form 10-K.

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

None.

Item 3. Defaults Upon Senior Securities.

None.

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

None.

Item 5. Other Information.

None.

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Item 6. Exhibits

(a) Exhibits

<u>Exhibit No.</u>	<u>Exhibit Description</u>
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)).
3.1a	Certificate of Designation of Series 1 Preferred Stock of drugstore.com, inc. (incorporated by reference to Exhibit 3.1a to drugstore.com, inc.'s Quarterly Report on Form 10-Q for the Quarter Ended July 2, 2000 (SEC File No. 000-26137)).
3.2	Amended and Restated Bylaws of drugstore.com, inc. dated January 7, 2005 (incorporated by reference to Exhibit 3.2 to drugstore.com inc.'s Annual Report on Form 10-K for the Fiscal Year Ended January 1, 2006 (SEC File No. 000-26137)).
10.1	Third Amendment to Loan and Security Agreement between drugstore.com, inc. and Silicon Valley Bank dated as of March 16, 2006.
10.2	Amended and Restated Loan and Security Agreement between drugstore.com, inc. and Silicon Valley Bank dated as of December 29, 2004.
31.1	Certification of Dawn G. Lepore, President, Chief Executive Officer and Chairman of the Board of drugstore.com, inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Robert A. Barton, Vice President, Chief Financial Officer and Treasurer of drugstore.com, inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Dawn G. Lepore, President, Chief Executive Officer and Chairman of the Board 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 A. Barton, Vice President, Chief Financial Officer and Treasurer 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 A. Barton
Robert A. Barton
Vice President, Chief Financial Officer and Treasurer
(Principal Financial Officer)

Date: May 12, 2006

**THIRD AMENDMENT
TO
LOAN AND SECURITY AGREEMENT**

THIS **THIRD AMENDMENT** to Loan and Security Agreement (this "Amendment") is entered into this [16th] day of March, 2006, by and between Silicon Valley Bank ("Bank") and DRUGSTORE.COM, INC., a Delaware corporation ("Borrower") whose address is 411 108th Avenue NE, Suite 1400, Bellevue, WA 98004.

RECITALS

A. Bank and Borrower have entered into that certain Amended and Restated Loan and Security Agreement dated as of December 29, 2004, as amended by that certain First Amendment to Loan and Security Agreement by and between Bank and Borrower dated as of August 4, 2005 and that certain Second Amendment to Loan and Security Agreement between Bank and Borrower dated as of December 9, 2005 (collectively, as the same may from time to time be further amended, modified, supplemented or restated, the "Loan Agreement").

B. Bank has extended credit to Borrower for the purposes permitted in the Loan Agreement.

C. Borrower has requested that Bank amend the Loan Agreement to (i) increase the amount available to be borrowed under the Committed Revolving Line, (ii) extend the maturity date, (iii) revise the financial covenants, and (iv) make certain other revisions to the Loan Agreement as more fully set forth herein.

D. Bank has agreed to so amend certain provisions of the Loan Agreement, but only to the extent, in accordance with the terms, subject to the conditions and in reliance upon the representations and warranties set forth below.

AGREEMENT

NOW, THEREFORE, in consideration of the foregoing recitals and other good and valuable consideration, the receipt and adequacy of which is hereby acknowledged, and intending to be legally bound, the parties hereto agree as follows:

1. Definitions. Capitalized terms used but not defined in this Amendment shall have the meanings given to them in the Loan Agreement.

2. Acknowledgement of Extension of Revolving Maturity Date. Prior to the date hereof, Borrower and Bank agreed that the "Revolving Maturity Date", as defined in Section 13 of the Loan Agreement, would be extended to March 15, 2006. No such agreement is effective unless in writing signed by Bank. Therefore, as of the date hereof, Borrower and Bank acknowledge and agree to such extension (such date to be further amended as set forth below).

3. Amendments to Loan Agreement.

(a) Section 2.1.2(d) . Section 2.1.2(d) is amended in its entirety and replaced with the following:

(d) As of the Term Loan Conversion Date, Borrower elected to convert \$1,000,000 of the Advances into a term loan (the "Term Loan"), which is being repaid by Borrower in equal monthly installments of principal in the amount of \$27,777.78, plus all accrued interest, on the first day of each month. On the date which is 36 months from the first day of the month following the Term Loan Conversion Date, Borrower shall repay all outstanding Term Loan principal and accrued interest. Any amounts repaid with respect to the Term Loan may not be reborrowed pursuant to the Term Loan and no additional amounts may be requested under the Term Loan.

(b) Section 2.1.2(e) . A new Section 2.1.2(e) is hereby added to read as follows:

(e) Notwithstanding the foregoing, Borrower may elect, upon 30 days prior written notice to Bank, to convert up to \$2,500,000 in the aggregate of the outstanding Advances into a term loan (the "Term Loan II"), provided that, at the time Borrower delivers any such notice, Borrower shall pay to Bank a nonrefundable fee equal to one quarter of one percent (0.25%) of the amount of the Term Loan II. Such notice may only be delivered during the 60 days immediately prior to the Revolving Maturity Date. On the first day of the month following the Term Loan II Conversion Date, Borrower shall pay any accrued but unpaid interest with respect to the Term Loan II and the Advances which were converted into the Term Loan II. Beginning on the first day of the next month, Borrower will repay the Term Loan in 36 equal monthly installments of principal plus interest. On the date which is 36 months from the first day of the month following the Term Loan II Conversion Date, Borrower shall repay all outstanding Term Loan II principal and accrued interest. Borrower may only request one Term Loan II hereunder.

(c) Section 2.4.2 (Additional Interest Rates; Payments) .

Section 2.4.2(i) is hereby amended to read "(i) Advances accrue interest on the outstanding principal balance at a per annum rate equal to the Prime Rate;"

A new Section 2.4.2(iv) is hereby added to the first sentence of Section 2.4.2 to read "(iv) the Term Loan II accrues interest on the outstanding principal balance at a floating per annum rate equal to one half of one percentage point (0.50%) above the greater of (A) the Prime Rate as in effect from time to time and (B) the Prime Rate as of the Term Loan Conversion Date".

(d) Section 6.7 (Financial Covenants) . Section 6.7 is amended in its entirety and replaced with the following:

6.7 Financial Covenants . Borrower will maintain:

(i) Cash Balance . At all times, a balance of unrestricted cash of at least \$20,000,000.

(ii) EBITDA Loss . As of the last day of each month, Borrower's EBITDA Loss for the three months immediately preceding the date of measurement shall not exceed (i) through the month ending March 31, 2006, (\$5,000,000), (ii) thereafter through the month ending June 30, 2006, (\$2,750,000), (iii) thereafter through the month ending September 30, 2006, (\$1,250,000), and (iv) for each month thereafter, Zero (\$0).

(e) Section 13 (Definitions) . Section 13.1 is hereby amended to add or amend the following defined terms to read as follows:

" **Committed Revolving Line** " is an Advance of up to \$7,500,000.

" **Revolving Maturity Date** " is March 14, 2007.

" **Term Loan II Conversion Date** " means the date on which Advances are converted into the Term Loan II pursuant to Section 2.1.2(e) hereof.

(f) Exhibit C (Compliance Certificate) . Exhibit C is amended in its entirety and replaced with Exhibit C attached hereto.

4. Limitation of Amendments.

(a) The amendments set forth in **Section 2** , above, are effective for the purposes set forth herein and shall be limited precisely as written and shall not be deemed to (a) be a consent to any amendment, waiver or modification of any other term or condition of any Loan Document, or (b) otherwise prejudice any right or remedy which Bank may now have or may have in the future under or in connection with any Loan Document.

(b) This Amendment shall be construed in connection with and as part of the Loan Documents and all terms, conditions, representations, warranties, covenants and agreements set forth in the Loan Documents, except as herein amended, are hereby ratified and confirmed and shall remain in full force and effect.

5. Representations and Warranties. To induce Bank to enter into this Amendment, Borrower hereby represents and warrants to Bank as follows:

(a) Immediately after giving effect to this Amendment (a) the representations and warranties contained in the Loan Documents are true, accurate and complete in all material respects as of the date hereof (except to the extent such representations and warranties relate to an earlier date, in which case they are true and correct as of such date), and (b) no Event of Default has occurred and is continuing;

(b) Borrower has the power and authority to execute and deliver this Amendment and to perform its obligations under the Loan Agreement, as amended by this Amendment;

(c) The organizational documents of Borrower delivered to Bank prior to the Effective Date remain true, accurate and complete and have not been amended, supplemented or restated and are and continue to be in full force and effect;

(d) The execution and delivery by Borrower of this Amendment and the performance by Borrower of its obligations under the Loan Agreement, as amended by this Amendment, have been duly authorized;

(e) The execution and delivery by Borrower of this Amendment and the performance by Borrower of its obligations under the Loan Agreement, as amended by this Amendment, do not and will not contravene (a) any law or regulation binding on or affecting Borrower, (b) any contractual restriction with a Person binding on Borrower, (c) any order, judgment or decree of any court or other governmental or public body or authority, or subdivision thereof, binding on Borrower, or (d) the organizational documents of Borrower;

(f) The execution and delivery by Borrower of this Amendment and the performance by Borrower of its obligations under the Loan Agreement, as amended by this Amendment, do not require any order, consent, approval, license, authorization or validation of, or filing, recording or registration with, or exemption by any governmental or public body or authority, or subdivision thereof, binding on either Borrower, except as already has been obtained or made; and

(g) This Amendment has been duly executed and delivered by Borrower and is the binding obligation of Borrower, enforceable against Borrower in accordance with its terms, except as such enforceability may be limited by bankruptcy, insolvency, reorganization, liquidation, moratorium or other similar laws of general application and equitable principles relating to or affecting creditors' rights.

6. Counterparts. This Amendment may be executed in any number of counterparts and all of such counterparts taken together shall be deemed to constitute one and the same instrument.

7. Effectiveness . This Amendment shall be deemed effective as of March [16], 2006, upon (a) the due execution and delivery to Bank of this Amendment and the Borrowing Resolutions by each party thereto, and (b) Borrower's payment of a nonrefundable amendment fee in an amount equal to \$19,375.

[Signature page follows.]

I N W ITNESS W HEREOF, the parties hereto have caused this Amendment to be duly executed and delivered as of the date first written above.

BANK

Silicon Valley Bank

By: /s/ Scott Bergquist

Name: Scott Bergquist

Title: Division Manager

BORROWER

DRUGSTORE.COM, INC.

By: /s/ Robert Barton

Name: Robert Barton

Title: CFO

/s/ Dawn G. Lepore

EXHIBIT C

COMPLIANCE CERTIFICATE

TO: SILICON VALLEY BANK
FROM: DRUGSTORE.COM, INC.

Date: _____

The undersigned authorized officer of DRUGSTORE.COM, INC. ("Borrower") certifies that under the terms and conditions of the Loan and Security Agreement between Borrower and Bank (the "Agreement"), (1) Borrower is in complete compliance for the period ending _____ with all required covenants except as noted below, (2) there are no Events of Default, (3) all representations and warranties in the Agreement are true and correct in all material respects on this date except as noted below; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date, (4) Borrower, and each of its Subsidiaries, has timely filed all required tax returns and reports, and Borrower has timely paid all foreign, federal, state and local taxes, assessments, deposits and contributions owed by Borrower, and (5) no Liens have been levied or claims made against Borrower or any of its Subsidiaries relating to unpaid employee payroll or benefits of which Borrower has not previously provided written notification to Bank. Attached are the required documents supporting the certification. The undersigned certifies that these are prepared in accordance with generally GAAP consistently applied from one period to the next except as explained in an accompanying letter or footnotes. The undersigned acknowledges that no borrowings may be requested at any time or date of determination that Borrower is not in compliance with any of the terms of the Agreement, and that compliance is determined not just at the date this certificate is delivered. Capitalized terms used but not otherwise defined herein shall have the meanings given them in the Agreement.

Please indicate compliance status by circling Yes/No under "Complies" column.

<u>Reporting Covenant</u>	<u>Required</u>	<u>Complies</u>	
Monthly financial statements + CC	Monthly within 30 days	Yes	No
Annual (Audited)	FYE within 120 days	Yes	No
10-Q, 10-K and 8-K	Within 5 days after filing with SEC	Yes	No

<u>Financial Covenant</u>	<u>Required</u>	<u>Actual</u>	<u>Complies</u>	
Maximum Trailing 3 Mo. EBITDA Loss	See Section 6.7(ii)	\$ _____	Yes	No
Minimum Cash	\$20,000,000	\$ _____	Yes	No

Borrower has deposit accounts located at the following institutions: _____

DRUGSTORE.COM, INC.

BANK USE ONLY

By: _____
Name: _____
Title: _____

Received by: _____
AUTHORIZED SIGNER

Date: _____
Verified: _____
AUTHORIZED SIGNER

Date: _____
Compliance Status: _____ Yes No

**AMENDED AND RESTATED LOAN AND SECURITY AGREEMENT
DRUGSTORE.COM, INC.**

This AMENDED AND RESTATED LOAN AND SECURITY AGREEMENT dated as of the Effective Date, between SILICON VALLEY BANK ("Bank"), whose address is 3003 Tasman Drive, Santa Clara, California 95054 with a loan production office located at 4110 Carillon Point, Kirkland, Washington 98033 and DRUGSTORE.COM, INC. ("Borrower"), whose address is 13920 SE Eastgate Way, Suite 300, Bellevue, Washington 98005 provides the terms on which Bank will lend to Borrower and Borrower will repay Bank. The parties agree as follows:

1. ACCOUNTING AND OTHER TERMS. Accounting terms not defined in this Agreement will be construed following GAAP. Calculations and determinations must be made following GAAP. The term "financial statements" includes the notes and schedules. The terms "including" and "includes" always mean "including (or includes) without limitation," in this or any Loan Document.

2. LOAN AND TERMS OF PAYMENT.

2.1 Promise to Pay. Borrower promises to pay Bank the unpaid principal amount of all Credit Extensions and interest on the unpaid principal amount of the Credit Extensions.

2.1.1 Equipment Advances.

(a) Bank has made advances (each an "Equipment Advance" and, collectively, "Equipment Advances") to Borrower, in an outstanding amount equal to \$53,814.69 as of the Effective Date. Borrower shall not request nor receive any further Equipment Advances.

(b) Interest accrues from the date of each Equipment Advance at the rate in Section 2.3. Equipment Advances are payable in 24 equal monthly installments of principal, and accrued interest, beginning on the 5th day of each month following the respective Equipment Advance and ending 24 months thereafter (each, the "Equipment Maturity Date"). Equipment Advances when repaid may not be reborrowed.

(c) On the Equipment Maturity Date, with respect to each Equipment Advance, Borrower will pay, in addition to the unpaid principal and accrued interest and all other amounts due on such date with respect to such Equipment Advance, an amount equal to the Final Payment.

2.1.2 Revolving Advances.

(a) Bank will make Advances not exceeding (i) the Committed Revolving Line, minus (ii) the amount of all outstanding Letters of Credit (including drawn but unreimbursed Letters of Credit), minus (iii) the Cash Management Services Sublimit, minus (iv) the aggregate amount of any Advances which have been converted into the Term Loan. Amounts borrowed under this Section may be repaid and reborrowed prior to the Revolving Maturity Date.

(b) To obtain an Advance, Borrower must notify Bank by facsimile or telephone by 12:00 p.m. Pacific time on the Business Day the Advance is to be made. Borrower must promptly confirm the notification by delivering to Bank the Payment/Advance Form attached as Exhibit B. Bank will credit Advances to Borrower's deposit account. Bank may make Advances under this Agreement based on instructions from a Responsible Officer or his or her designee or without instructions if the Advances are necessary to meet Obligations which have become due. Bank may rely on any telephone notice given by a person whom Bank believes is a Responsible Officer or designee. Borrower will indemnify Bank for any loss Bank suffers due to such reliance.

(c) The Committed Revolving Line terminates on the Revolving Maturity Date, when, subject to the term out option described below, all Advances are immediately payable.

(d) Notwithstanding the foregoing, Borrower may elect, upon 30 days prior written notice to Bank, to convert any or all of the outstanding Advances into a term loan (the "Term Loan"), provided that, at the time Borrower delivers any such notice, Borrower shall pay to Bank a nonrefundable fee equal

to one half of one percent (0.5%) of the amount of the Term Loan. Such notice may only be delivered during the 60 days immediately prior to the Revolving Maturity Date. On the first day of the month following the Term Loan Conversion Date, Borrower shall pay any accrued but unpaid interest with respect to the Term Loan and the Advances which were converted into the Term Loan. Beginning on the first day of the next month, Borrower will repay the Term Loan in 36 equal monthly installments of principal plus interest. On the date which is 36 months from the first day of the month following the Term Loan Conversion Date, Borrower shall repay all outstanding Term Loan principal and accrued interest. Borrower may only request one Term Loan hereunder.

2.1.3 Letters of Credit Sublimit. Bank will issue or have issued Letters of Credit for Borrower's account not exceeding (i) the Committed Revolving Line minus (ii) the outstanding principal balance of the Advances (including any Advances which have been converted into a Term Loan) minus the Cash Management Sublimit; however, the face amount of outstanding Letters of Credit (including drawn but unreimbursed Letters of Credit) may not exceed \$2,000,000. All Letters of Credit shall be, in form and substance, acceptable to Bank in its sole discretion and shall be subject to the terms and conditions of Bank's form of standard application and letter of credit agreement, which Borrower hereby agrees to execute, including a fee equal to 1.15% per annum of the face amount of each Letter of Credit. Borrower's Letter of Credit reimbursement obligation will be secured by unencumbered cash in a certificate of deposit at Bank on terms acceptable to Bank at least five (5) Business Days prior to the Revolving Maturity Date if such date is not extended by Bank. Borrower agrees to execute any further documentation in connection with the Letters of Credit as Bank may reasonably request.

2.1.4 Cash Management Services Sublimit. Borrower may use up to \$500,000 for Bank's Cash Management Services, which may include merchant services, direct deposit of payroll, business credit card, and check cashing services identified in various cash management services agreements related to such services (the "Cash Management Services"). All amounts Bank pays for any Cash Management Services will be treated as Advances under the Committed Revolving Line.

2.1.5 Non-Formula Equipment Advance.

(a) On the Closing Date, Bank will make an advance (the "Non-Formula Equipment Advance") in an amount not to exceed \$2,000,000. The Non-Formula Equipment Advance may only be used to finance or refinance Equipment and software purchased by Borrower between January 1, 2004 and the Effective Date.

(b) On January 1, 2005, Borrower shall pay all accrued interest with respect to the Non-Formula Equipment Advance. The Non-Formula Equipment Advance shall be payable in 36 equal monthly installments of principal, plus accrued interest, beginning on February 1, 2005 and ending on January 1, 2008. The Facility B Equipment Advance, or any portion thereof, when repaid may not be reborrowed. Borrower may prepay the Non-Formula Equipment Advance, or any portion thereof, by paying the applicable principal amount and any accrued interest thereon to Bank, provided that, if the prepayment is made on or before the first anniversary of the Effective Date, Borrower shall also pay a Make-Whole Premium to Bank at the time of such prepayment.

(c) To obtain the Non-Formula Equipment Advance, Borrower must notify Bank (the notice is irrevocable) by facsimile no later than 12:00 p.m. Pacific time 1 Business Day before the day on which the Non-Formula Equipment Advance is to be made. The notice in the form of Exhibit B (Payment/Advance Form) must be signed by a Responsible Officer or designee.

2.2 Termination of Commitment to Lend. Bank's obligation to lend the undisbursed portion of the Obligations will terminate if, in Bank's sole discretion, there has been a material adverse change in the general affairs, management, results of operation, condition (financial or otherwise) or the prospect of repayment of the Obligations, or there has been any material adverse deviation by Borrower from the most recent business plan of Borrower presented to and accepted by Bank prior to the execution of this Agreement.

2.3 Overadvances. If Borrower's Obligations under Sections 2.1.2, 2.1.3, and 2.1.4 exceed the Committed Revolving Line at any time, Borrower must immediately pay Bank the excess.

2.4 Interest Rate, Payments.

2.4.1 Equipment Advances. Equipment Advances accrue interest on the outstanding principal balance at a per annum fixed rate of 5.75%. After an Event of Default, Obligations accrue interest at 5 percent above the rate effective immediately before the Event of Default. Interest is computed on a 360 day year for the actual number of days elapsed.

2.4.2 Additional Interest Rates; Payments.

(a) Interest Rate. (i) Advances accrue interest on the outstanding principal balance at a per annum rate one quarter of one percentage point (0.25%) above the Prime Rate; (ii) the Term Loan accrues interest on the outstanding principal balance at a per annum rate equal to one half of one percentage point (0.50%) above the greater of (A) the Prime Rate, as revised from time to time according to the terms hereof, and (B) the Prime Rate as of the Term Loan Conversion Date, and (iii) the Non-Formula Equipment Advance shall accrue interest on the outstanding principal balance at a per annum rate equal to the greater of (A) one half of one percentage point (0.5%) above the Prime Rate and (B) five percent (5.0%). After an Event of Default, Obligations accrue interest at 5 percent above the rate effective immediately before the Event of Default. The interest rate increases or decreases when the Prime Rate changes. Interest is computed on a 360 day year for the actual number of days elapsed.

(b) Payments. Interest due on the Committed Revolving Line is payable on the first day of each month. Payments received after 12:00 noon Pacific time are considered received at the opening of business on the next Business Day. When a payment is due on a day that is not a Business Day, the payment is due the next Business Day and additional interest shall accrue.

2.4.3 Request to Debit Accounts. Bank may debit any of Borrower's deposit accounts including Account Number 3300380008 for principal and interest payments or any amounts Borrower owes Bank when due. Bank will notify Borrower when it debits Borrower's accounts. These debits are not a set-off.

2.5 Fees. Borrower will pay:

(a) Facility Fee. A fully earned Facility Fee of \$15,000 for the Committed Revolving Line (which shall be non-refundable unless Borrower has complied with Section 6.6 prior to March 31, 2005, in which case such amount shall be refunded to Borrower), and a fully earned non-refundable Facility Fee of \$10,000 for the Non-Formula Equipment Advance; and

(b) Bank Expenses. All Bank Expenses (including reasonable attorneys' fees and reasonable expenses) incurred through and after the date of this Agreement, are payable when due.

3. CONDITIONS OF LOANS.

3.1 Conditions Precedent to Initial Credit Extension. Bank's obligation to make the initial Credit Extension is subject to the condition precedent that it receive the agreements, documents and fees it requires.

3.2 Conditions Precedent to all Credit Extensions. Bank's obligations to make each Credit Extension, including the initial Credit Extension, is subject to the following:

(a) timely receipt of any Payment/Advance Form; and

(b) the representations and warranties in Section 5 must be materially true on the date of the Payment/Advance Form and on the effective date of each Credit Extension and no Event of Default may have occurred and be continuing, or result from the Credit Extension. Each Credit Extension is Borrower's representation and warranty on that date that the representations and warranties of Section 5 remain true.

4. CREATION OF SECURITY INTEREST.

4.1 Grant of Security Interest. Borrower grants Bank a continuing security interest in all presently existing and later acquired Collateral to secure all Obligations and performance of each of Borrower's duties under the Loan Documents. Except for Permitted Liens, any security interest will be a first priority security interest in the Collateral. If this Agreement is terminated, Bank's lien and security interest in the Collateral will continue until Borrower fully satisfies its Obligations.

4.2 Authorization of File. Borrower authorizes Bank to file financing statements without notice to Borrower, with all appropriate jurisdictions, as Bank deems appropriate, in order to perfect or protect Bank's interest in the Collateral.

5. REPRESENTATIONS AND WARRANTIES. Borrower represents and warrants as follows:

5.1 Due Organization and Authorization. Borrower and each Subsidiary is duly existing and in good standing in its state of formation and qualified and licensed to do business in, and in good standing in, any state in which the conduct of its business or its ownership of property requires that it be qualified, except where the failure to do so could not reasonably be expected to cause a Material Adverse Change. Borrower has not changed its state of formation or its organizational structure or type or any organizational number (if any) assigned by its jurisdiction of formation.

The execution, delivery and performance of the Loan Documents have been duly authorized, and do not conflict with Borrower's formation documents, nor constitute an event of default under any material agreement by which Borrower is bound. Borrower is not in default under any agreement to which or by which it is bound in which the default could reasonably be expected to cause a Material Adverse Change.

5.2 Collateral. Borrower has good title to the Collateral, free of Liens except Permitted Liens or Borrower has Rights to each asset that is Collateral. Borrower has no other deposit account, other than the deposit accounts described in the Schedule. The Accounts are bona fide, existing obligations, and the service or property has been performed or delivered to the account debtor or its agent for immediate shipment to and unconditional acceptance by the account debtor. The Collateral is not in the possession of any third party bailee (such as at a warehouse). In the event that Borrower, after the date hereof, intends to store or otherwise deliver the Collateral to such a bailee, then Borrower will receive the prior written consent of Bank and such bailee must acknowledge in writing that the bailee is holding such Collateral for the benefit of Bank. All Inventory is in all material respects of good and marketable quality, free from material defects.

5.3 Litigation. Except as shown in the Schedule, there are no actions or proceedings pending or, to the Borrower's knowledge, threatened by or against Borrower or any Subsidiary in which a likely adverse decision could reasonably be expected to result in damages or costs to Borrower or any Subsidiary of \$250,000 or more.

5.4 No Material Adverse Change in Financial Statements. All consolidated financial statements for Borrower, and any Subsidiary, delivered to Bank fairly present in all material respects Borrower's consolidated financial condition and Borrower's consolidated results of operations for the period covered by such statements. There has not been any material deterioration in Borrower's consolidated financial condition since the date of the most recent financial statements submitted to Bank.

5.5 Solvency. The fair salable value of Borrower's assets (including goodwill minus disposition costs) exceeds the fair value of its liabilities; the Borrower is not left with unreasonably small capital after the transactions in this Agreement; and Borrower is able to pay its debts (including trade debts) as they mature.

5.6 Regulatory Compliance. Borrower is not an "investment company" or a company "controlled" by an "investment company" under the Investment Company Act. Borrower is not engaged as one of its important activities in extending credit for margin stock (under Regulations T and U of the Federal Reserve Board of Governors). Borrower has complied in all material respects with the Federal Fair Labor Standards Act.

Borrower has not violated any laws, ordinances or rules, the violation of which could reasonably be expected to cause a Material Adverse Change. None of Borrower's or any Subsidiary's properties or assets has been used by Borrower or any Subsidiary or, to the best of Borrower's knowledge, by previous Persons, in disposing, producing, storing, treating, or transporting any hazardous substance other than legally. Borrower and each Subsidiary has timely filed all required tax returns and paid, or made adequate provision to pay, all material taxes, except those being contested in good faith with adequate reserves under GAAP. Borrower and each Subsidiary has obtained all consents, approvals and authorizations of, made all declarations or filings with, and given all notices to, all government authorities that are necessary to continue its business as currently conducted, except where the failure to do so could not reasonably be expected to cause a Material Adverse Change.

5.7 Investments in Subsidiaries. Borrower does not own any stock, partnership interest or other equity securities except for Permitted Investments.

5.8 Full Disclosure. No written representation, warranty or other statement of Borrower in any certificate or written statement given to Bank (taken together with all such written certificates and written statements to Bank) contains any untrue statement of a material fact or omits to state a material fact necessary to make the statements contained in the certificates or statements not misleading. It being recognized by Bank that the projections and forecasts provided by Borrower in good faith and based upon reasonable assumptions are not viewed as facts and that actual results during the period or periods covered by such projections and forecasts may differ from the projected and forecasted results.

6. AFFIRMATIVE COVENANTS. Borrower will do all of the following for so long as Bank has an obligation to lend, or there are outstanding Obligations:

6.1 Government Compliance. Borrower will maintain its and all Subsidiaries' legal existence and good standing in its jurisdiction of formation and maintain qualification in each jurisdiction in which the failure to so qualify would reasonably be expected to cause a material adverse effect on Borrower's business or operations. Borrower will comply, and have each Subsidiary comply, with all laws, ordinances and regulations to which it is subject, noncompliance with which could have a material adverse effect on Borrower's business or operations or would reasonably be expected to cause a Material Adverse Change.

6.2 Financial Statements, Reports, Certificates.

(a) Borrower will deliver to Bank: (i) as soon as available, but no later than 30 days after the last day of each month, a company prepared consolidated balance sheet and income statement covering Borrower's consolidated operations during the period certified by a Responsible Officer and in a form acceptable to Bank; (ii) as soon as available, but no later than 120 days after the last day of Borrower's fiscal year, audited consolidated financial statements prepared under GAAP, consistently applied, together with an unqualified opinion on the financial statements from an independent certified public accounting firm reasonably acceptable to Bank; (iii) within 5 days of filing, copies of all statements, reports and notices made available to Borrower's security holders or to any holders of Subordinated Debt and all reports on Form 10-K, 10-Q and 8-K filed with the Securities and Exchange Commission; (iv) a prompt report of any legal actions pending or threatened against Borrower or any Subsidiary that could result in damages or costs to Borrower or any Subsidiary of \$250,000 or more; and (v) budgets, sales projections, operating plans or other financial information Bank reasonably requests.

(b) Within 30 days after the last day of each month, Borrower will deliver to Bank with the monthly financial statements a Compliance Certificate signed by a Responsible Officer in the form of Exhibit C.

(c) Allow Bank to audit Borrower's Collateral at Borrower's expense. Such audits will be conducted no more often than every year unless an Event of Default has occurred and is continuing.

6.3 Inventory; Returns. Borrower will keep all Inventory in good and marketable condition, free from material defects. Returns and allowances between Borrower and its account debtors will follow

Borrower's customary practices as they exist at execution of this Agreement. Borrower must promptly notify Bank of all returns, recoveries, disputes and claims, that involve more than \$250,000.

6.4 Taxes . Borrower will make, and cause each Subsidiary to make, timely payment of all material federal, state, and local taxes or assessments and will deliver to Bank, on demand, appropriate certificates attesting to the payment.

6.5 Insurance . Borrower will keep its business and the Collateral insured for risks and in amounts, as is consistently required in Borrower's industry. Insurance policies will be in a form, with companies, and in amounts that are satisfactory to Bank in Bank's reasonable discretion. All property policies will have a lender's loss payable endorsement showing Bank as an additional loss payee and all liability policies will show the Bank as an additional insured and provide that the insurer must give Bank at least 20 days notice before canceling its policy. At Bank's request, Borrower will deliver certified copies of policies and evidence of all premium payments. Proceeds payable under any policy will, at Bank's option, be payable to Bank on account of the Obligations.

Statutory notice regarding insurance:

WARNING

Unless you provide us with evidence of the insurance coverage as required by our contract or loan agreement, we may purchase insurance at your expense to protect our interest. This insurance may, but need not, also protect your interest. If the collateral becomes damaged, the coverage we purchase may not pay any claim you make or any claim made against you. You may later cancel this coverage by providing evidence that you have obtained property coverage elsewhere.

You are responsible for the cost of any insurance purchased by us. The cost of this insurance may be added to your contract or loan balance. If the cost is added to your contract or loan balance, the interest rate on the underlying contract or loan will apply to this added amount. The effective date of coverage may be the date your prior coverage lapsed or the date you failed to provide proof of coverage.

This coverage we purchased may be considerably more expensive than insurance you can obtain on your own and may not satisfy any need for property damage coverage or any mandatory liability insurance requirements imposed by applicable law.

6.6 Primary Accounts . Borrower will maintain its primary depository and operating accounts (excluding merchant services) with Bank, such accounts to be established no later than June 30, 2005

6.7 Financial Covenants . Borrower will maintain:

(i) Cash Balance . At all times, a balance of unrestricted cash of at least \$15,000,000; and

(ii) EBITDA Loss . As of the last day of each month, Borrower's EBITDA Loss for the three months immediately preceding the date of measurement shall not exceed \$3,500,000.

6.8 Intellectual Property Rights . Borrower will (i) protect, defend and maintain the validity and enforceability of the Intellectual Property and promptly advise Bank in writing of material infringements and (ii) not allow any Intellectual Property to be abandoned, forfeited or dedicated to the public without Bank's written consent.

6.9 Landlord Waivers . On or before April 1, 2005, (A) Borrower will deliver to Bank an original Consent to Removal of Personal Property in form and substance acceptable to Bank (a "Landlord Waiver"), duly executed and delivered by Borrower's landlord for its new headquarters office at One Bellevue Center, 411 108th Ave NE, 12th floor, Bellevue, WA 98004, and (B) Borrower will use its best efforts to deliver a Landlord Waiver, duly executed and delivered by Borrower's landlord for its fulfillment centers located at each of the

following addresses: (i) International Vision Direct-Distribution Center, 5500 Hovander Road, Ferndale, WA 98248, (ii) Exodus, 12301 Tukwila International Boulevard, Tukwila, WA 98168, and (iii) drugstore.com, Distribution Ctr., 407 Heron Drive, Building A, Bridgeport, NJ 08014.

6.10 Further Assurances. Borrower will execute any further instruments and take further action as Bank reasonably requests to perfect or continue Bank's security interest in the Collateral or to effect the purposes of this Agreement.

7. NEGATIVE COVENANTS. For so long as Bank has an obligation to lend or there are any outstanding Obligations, Borrower shall not, without Bank's prior written consent (which shall be a matter of its good faith business judgment), do any of the following:

7.1 Dispositions. Convey, sell, lease, transfer or otherwise dispose of (collectively "Transfer"), or permit any of its Subsidiaries to Transfer, all or any part of its business or property (including its intellectual property), except for Transfers (i) of Inventory in the ordinary course of business; (ii) of non-exclusive licenses and similar arrangements for the use of the property of Borrower or its Subsidiaries in the ordinary course of business; or (iii) of worn-out or obsolete Equipment.

7.2 Changes in Business, Ownership, Management or Locations of Collateral. Engage in or permit any of its Subsidiaries to engage in any business other than the businesses currently engaged in by Borrower or reasonably related thereto or have a material change in its ownership of greater than 25% or have a material change in senior management. Borrower will not, without at least 30 days prior written notice, relocate its chief executive office (other than to One Bellevue Center, 411 108th Ave NE, 12th floor, Bellevue, WA 98004), change its state of formation (including reincorporation), change its organizational number or name or add any new offices or business locations (such as warehouses) in which Borrower maintains or stores over \$100,000 in Collateral.

7.3 Mergers or Acquisitions. Merge or consolidate, or permit any of its Subsidiaries to merge or consolidate, with any other Person, or acquire, or permit any of its Subsidiaries to acquire, all or substantially all of the capital stock or property of another Person, except where (i) no Event of Default has occurred and is continuing or would result from such action during the term of this Agreement and (ii) such transaction would not result in a decrease of more than 25% of Tangible Net Worth. A Subsidiary may merge or consolidate into another Subsidiary or into Borrower.

7.4 Indebtedness. Create, incur, assume, or be liable for any Indebtedness, or permit any Subsidiary to do so, other than Permitted Indebtedness.

7.5 Encumbrance. Create, incur, or allow any Lien on any of its property (including its intellectual property), or assign or convey any right to receive income, including the sale of any Accounts, or permit any of its Subsidiaries to do so, except for Permitted Liens, or permit any Collateral not to be subject to the first priority security interest granted here, subject to Permitted Liens.

7.6 Distributions; Investments. Directly or indirectly acquire or own any Person, or make any Investment in any Person, other than Permitted Investments, or permit any of its Subsidiaries to do so. Pay any dividends or make any distribution or payment or redeem, retire or purchase any capital stock.

7.7 Transactions with Affiliates. Directly or indirectly enter into or permit to exist any material transaction with any Affiliate of Borrower except for transactions that are in the ordinary course of Borrower's business, upon fair and reasonable terms that are no less favorable to Borrower than would be obtained in an arm's length transaction with a nonaffiliated Person.

7.8 Subordinated Debt. Make or permit any payment on any Subordinated Debt, except under the terms of the Subordinated Debt, or amend any provision in any document relating to the Subordinated Debt without Bank's prior written consent.

7.9 Compliance. Become an “investment company” or a company controlled by an “investment company,” under the Investment Company Act of 1940 or undertake as one of its important activities extending credit to purchase or carry margin stock, or use the proceeds of any Credit Extension for that purpose; fail to meet the minimum funding requirements of ERISA, permit a Reportable Event or Prohibited Transaction, as defined in ERISA, to occur; fail to comply with the Federal Fair Labor Standards Act or violate any other law or regulation, if the violation could reasonably be expected to have a material adverse effect on Borrower’s business or operations or would reasonably be expected to cause a Material Adverse Change, or permit any of its Subsidiaries to do so.

8. EVENTS OF DEFAULT. Any one of the following is an Event of Default:

8.1 Payment Default. If Borrower fails to pay any of the Obligations within 5 Business Days after their due date, however, during such period no Credit Extensions will be made;

8.2 Covenant Default.

(a) If Borrower fails to perform any obligation under Sections 6.2 or 6.7 or violates any of the covenants contained in Section 7 of this Agreement, provided, however, that failure to perform under Section 6.7 may be cured by the pledge, within five Business Days of such failure to perform, of unrestricted, unencumbered cash at Bank in an amount sufficient to secure the entire amount of the Obligations (including without limitation any outstanding Letters of Credit and Cash Management Services) then outstanding on terms satisfactory to Bank (provided that, after such cure, Bank shall have no further obligation to make Credit Extensions to Borrower which are not cash secured), or

(b) If Borrower fails or neglects to perform, keep, or observe any other material term, provision, condition, covenant, or agreement contained in this Agreement, in any of the Loan Documents, or in any other present or future agreement between Borrower and Bank and as to any default under such other term, provision, condition, covenant or agreement that can be cured, has failed to cure such default within ten (10) days after the occurrence thereof; provided, however, that if the default cannot by its nature be cured within the ten (10) day period or cannot after diligent attempts by Borrower be cured within such ten (10) day period, and such default is likely to be cured within a reasonable time, then Borrower shall have an additional reasonable period (which shall not in any case exceed thirty (30) days) to attempt to cure such default, and within such reasonable time period the failure to have cured such default shall not be deemed an Event of Default (provided that no Credit Extensions will be made during such cure period);

8.3 Material Adverse Change. If there (i) occurs a material adverse change in the business, operations, or financial condition of the Borrower, or (ii) is a material impairment of the prospect of repayment of any portion of the Obligations; or (iii) is a material impairment of the value or priority of Bank’s security interests in the Collateral (the foregoing being defined as a “Material Adverse Change”).

8.4 Attachment. If any material portion of Borrower’s assets is attached, seized, levied on, or comes into possession of a trustee or receiver and the attachment, seizure or levy is not removed in 10 days, or if Borrower is enjoined, restrained, or prevented by court order from conducting a material part of its business or if a judgment or other claim becomes a Lien on a material portion of Borrower’s assets, or if a notice of lien, levy, or assessment is filed against any of Borrower’s assets by any government agency and not paid within 10 days after Borrower receives notice. These are not Events of Default if stayed or if a bond is posted pending contest by Borrower (but no Credit Extensions will be made during the cure period);

8.5 Insolvency. If Borrower becomes insolvent or if Borrower begins an Insolvency Proceeding or an Insolvency Proceeding is begun against Borrower and not dismissed or stayed within 30 days (but no Credit Extensions will be made before any Insolvency Proceeding is dismissed);

8.6 Other Agreements. If there is a default in any agreement between Borrower and a third party that gives the third party the right to accelerate any Indebtedness exceeding \$100,000 or that could cause a Material Adverse Change;

8.7 Judgments. If a money judgment(s) in the aggregate of at least \$250,000 is rendered against Borrower and is unsatisfied and unstayed for 10 days (but no Credit Extensions will be made before the judgment is stayed or satisfied); or

8.8 Misrepresentations. If Borrower or any Person acting for Borrower makes any material misrepresentation or material misstatement now or later in any warranty or representation in this Agreement or in any writing delivered to Bank or to induce Bank to enter this Agreement or any Loan Document.

9. BANK'S RIGHTS AND REMEDIES.

9.1 Rights and Remedies. When an Event of Default occurs and continues Bank may, without notice or demand, do any or all of the following:

(a) Declare all Obligations immediately due and payable (but if an Event of Default described in Section 8.5 occurs all Obligations are immediately due and payable without any action by Bank);

(b) Stop advancing money or extending credit for Borrower's benefit under this Agreement or under any other agreement between Borrower and Bank;

(c) Settle or adjust disputes and claims directly with account debtors for amounts, on terms and in any order that Bank considers advisable; notify any Person owing Borrower money of Bank's security interest in the funds and verify the amount of the Account. Borrower must collect all payments in trust for Bank and, if requested by Bank, immediately deliver the payments to Bank in the form received from the account debtor, with proper endorsements for deposit;

(d) Make any payments and do any acts it considers necessary or reasonable to protect its security interest in the Collateral, provided such acts are permissible under applicable law. Borrower will assemble the Collateral if Bank requires and make it available as Bank designates. Bank may enter premises where the Collateral is located, take and maintain possession of any part of the Collateral, and pay, purchase, contest, or compromise any Lien which appears to be prior or superior to its security interest and pay all expenses incurred. Borrower grants Bank a license to enter and occupy any of its premises, without charge, to exercise any of Bank's rights or remedies;

(e) Apply to the Obligations any (i) balances and deposits of Borrower it holds, or (ii) any amount held by Bank owing to or for the credit or the account of Borrower;

(f) Ship, reclaim, recover, store, finish, maintain, repair, prepare for sale, advertise for sale, and sell the Collateral. Bank is granted a non-exclusive, royalty-free license or other right to use, without charge, Borrower's labels, Patents, Copyrights, Mask Works, rights of use of any name, trade secrets, trade names, Trademarks, service marks, and advertising matter, or any similar property as it pertains to the Collateral, in completing production of, advertising for sale, and selling any Collateral and, in connection with Bank's exercise of its rights under this Section, Borrower's rights under all licenses and all franchise agreements inure to Bank's benefit; and

(g) Dispose of the Collateral according to the Code.

Bank may place a "hold" on any account maintained with Bank and deliver a notice of exclusive control, any entitlement order, or other directions or instructions pursuant to any control agreement or similar agreements providing control of any Collateral.

9.2 Power of Attorney. Effective only when an Event of Default occurs and continues, Borrower irrevocably appoints Bank as its lawful attorney to: (i) endorse Borrower's name on any checks or other forms of payment or security; (ii) sign Borrower's name on any invoice or bill of lading for any Account or drafts against account debtors, (iii) make, settle, and adjust all claims under Borrower's insurance policies; (iv) settle and adjust disputes and claims about the Accounts directly with account debtors, for amounts and on terms Bank

determines reasonable; and (v) transfer the Collateral into the name of Bank or a third party as the Code permits. Bank may exercise the power of attorney to sign Borrower's name on any documents necessary to perfect or continue the perfection of any security interest regardless of whether an Event of Default has occurred. Bank's appointment as Borrower's attorney in fact, and all of Bank's rights and powers, coupled with an interest, are irrevocable until all Obligations have been fully repaid and performed and Bank's obligation to provide Credit Extensions terminates.

9.3 Bank Expenses. If Borrower fails to pay any amount or furnish any required proof of payment to third persons, Bank may make all or part of the payment or obtain insurance policies required in Section 6.5, and take any action under the policies Bank deems prudent. Any amounts paid by Bank are Bank Expenses and immediately due and payable, bearing interest at the then applicable rate and secured by the Collateral. No payments by Bank are deemed an agreement to make similar payments in the future or Bank's waiver of any Event of Default.

9.4 Bank's Liability for Collateral. If Bank complies with reasonable banking practices and Section 9-207 of the Code, it is not liable for: (a) the safekeeping of the Collateral; (b) any loss or damage to the Collateral; (c) any diminution in the value of the Collateral; or (d) any act or default of any carrier, warehouseman, bailee, or other person. Except as provided above, Borrower bears all risk of loss, damage or destruction of the Collateral.

9.5 Remedies Cumulative. Bank's rights and remedies under this Agreement, the Loan Documents, and all other agreements are cumulative. Bank has all rights and remedies provided under the Code, by law, or in equity. Bank's exercise of one right or remedy is not an election, and Bank's waiver of any Event of Default is not a continuing waiver. Bank's delay is not a waiver, election, or acquiescence. No waiver is effective unless signed by Bank and then is only effective for the specific instance and purpose for which it was given.

9.6 Demand Waiver. Borrower waives demand, notice of default or dishonor, notice of payment and nonpayment, notice of any default, nonpayment at maturity, release, compromise, settlement, extension, or renewal of accounts, documents, instruments, chattel paper, and guarantees held by Bank on which Borrower is liable.

10. NOTICES. All notices or demands by any party about this Agreement or any other related agreement must be in writing and be personally delivered or sent by an overnight delivery service, by certified mail, postage prepaid, return receipt requested, or by telefacsimile to the addresses set forth at the beginning of this Agreement. A party may change its notice address by giving the other party written notice.

11. CHOICE OF LAW, VENUE AND JURY TRIAL WAIVER. California law governs the Loan Documents without regard to principles of conflicts of law. Borrower and Bank each submit to the exclusive jurisdiction of the State and Federal courts in King County, Washington.

BORROWER AND BANK EACH WAIVE THEIR RIGHT TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION ARISING OUT OF ANY OF THE LOAN DOCUMENTS OR ANY CONTEMPLATED TRANSACTION, INCLUDING CONTRACT, TORT, BREACH OF DUTY AND ALL OTHER CLAIMS. THIS WAIVER IS A MATERIAL INDUCEMENT FOR BOTH PARTIES TO ENTER INTO THIS AGREEMENT. EACH PARTY HAS REVIEWED THIS WAIVER WITH ITS COUNSEL.

12. GENERAL PROVISIONS.

12.1 Successors and Assigns. This Agreement binds and is for the benefit of the successors and permitted assigns of each party. Borrower may not assign this Agreement or any rights under it without Bank's prior written consent which may be granted or withheld in Bank's discretion. Bank has the right, without the consent of or notice to Borrower, to sell, transfer, negotiate, or grant participation in all or any part of, or any interest in, Bank's obligations, rights and benefits under this Agreement.

12.2 Indemnification. Borrower will indemnify, defend and hold harmless Bank and its officers, employees, and agents against: (a) all obligations, demands, claims, and liabilities asserted by any other party in connection with the transactions contemplated by the Loan Documents; and (b) all losses or Bank Expenses incurred, or paid by Bank from, following, or consequential to transactions between Bank and Borrower (including reasonable attorneys fees and expenses), except for losses caused by Bank's gross negligence or willful misconduct.

12.3 Time of Essence. Time is of the essence for the performance of all obligations in this Agreement.

12.4 Severability of Provision. Each provision of this Agreement is severable from every other provision in determining the enforceability of any provision.

12.5 Amendments in Writing, Integration. All amendments to this Agreement must be in writing and signed by Borrower and Bank. This Agreement represents the entire agreement about this subject matter, and supersedes prior negotiations or agreements. All prior agreements, understandings, representations, warranties, and negotiations between the parties about the subject matter of this Agreement merge into this Agreement and the Loan Documents. UNDER WASHINGTON AND OREGON LAW, MOST AGREEMENTS, PROMISES AND COMMITMENTS MADE BY THE BANK AFTER OCTOBER 3, 1989 CONCERNING LOANS AND OTHER CREDIT EXTENSIONS WHICH ARE NOT FOR PERSONAL, FAMILY OR HOUSEHOLD PURPOSES OR SECURED SOLELY BY THE BORROWER'S RESIDENCE MUST BE IN WRITING, EXPRESS CONSIDERATION AND BE SIGNED BY US TO BE ENFORCEABLE.

12.6 Counterparts. This Agreement may be executed in any number of counterparts and by different parties on separate counterparts, each of which, when executed and delivered, are an original, and all taken together, constitute one Agreement.

12.7 Survival. All covenants, representations and warranties made in this Agreement continue in full force while any Obligations remain outstanding. The obligations of Borrower in Section 12.2 to indemnify Bank will survive until all statutes of limitations for actions that may be brought against Bank have run.

12.8 Effect of Amendment and Restatement. This Agreement is intended to and does completely amend and restate, without novation, that certain Loan and Security Agreement between Bank and Borrower dated as of September 20, 2002, as amended (the "Original Agreement"). All security interests granted under the Original Agreement are hereby confirmed and ratified and shall continue to secure all Obligations under this Agreement.

12.9 Confidentiality. In handling any confidential information, Bank will exercise the same degree of care that it exercises for its own proprietary information, but disclosure of information may be made (i) to Bank's subsidiaries or affiliates in connection with their business with Borrower, (ii) to prospective transferees or purchasers of any interest in the loans (provided, however, Bank shall use commercially reasonable efforts in obtaining such prospective transferee or purchasers agreement of the terms of this provision), (iii) as required by law, regulation, subpoena, or other order, (iv) as required in connection with Bank's examination or audit and (v) as Bank considers appropriate exercising remedies under this Agreement. Confidential information does not include information that either: (a) is in the public domain or in Bank's possession when disclosed to Bank, or becomes part of the public domain after disclosure to Bank; or (b) is disclosed to Bank by a third party, if Bank does not know that the third party is prohibited from disclosing the information. Borrower and Bank have entered into a Mutual Confidentiality Agreement, dated August 20, 2002, such agreement shall remain in full force and effect.

12.10 Attorneys' Fees, Costs and Expenses. In any action or proceeding between Borrower and Bank arising out of the Loan Documents, the prevailing party will be entitled to recover its reasonable attorneys' fees and other reasonable costs and expenses incurred, in addition to any other relief to which it may be entitled.

13. DEFINITIONS.

13.1 Definitions. In this Agreement:

“ **Accounts** ” are all existing and later arising accounts, contract rights, and other obligations owed Borrower in connection with its sale or lease of goods (including licensing software and other technology) or provision of services, all credit insurance, guaranties, other security and all merchandise returned or reclaimed by Borrower and Borrower’s Books relating to any of the foregoing, as such definition may be amended from time to time according to the Code.

“ **Advance** ” or “ **Advances** ” is a loan advance (or advances) under the Committed Revolving Line (excluding, unless otherwise indicated, any Advances which have been converted to a Term Loan).

“ **Affiliate** ” of a Person is a Person that owns or controls directly or indirectly the Person, any Person that controls or is controlled by or is under common control with the Person, and each of that Person’s senior executive officers, directors, partners and, for any Person that is a limited liability company, that Person’s managers and members.

“ **Bank Expenses** ” are all audit fees and expenses and reasonable costs and expenses (including reasonable attorneys’ fees and expenses) for preparing, negotiating, administering, defending and enforcing the Loan Documents (including appeals or Insolvency Proceedings).

“ **Borrower’s Books** ” are all Borrower’s books and records including ledgers, records regarding Borrower’s assets or liabilities, the Collateral, business operations or financial condition and all computer programs or discs or any equipment containing the information.

“ **Business Day** ” is any day that is not a Saturday, Sunday or a day on which the Bank is closed.

“ **Cash Management Services** ” are defined in Section 2.1.4.

“ **Code** ” is the California Uniform Commercial Code, as applicable.

“ **Collateral** ” is the property described on Exhibit A .

“ **Committed Revolving Line** ” is an Advance of up to \$1,000,000, provided that, after Borrower has complied with Section 6.6, “Committed Revolving Line” shall mean an Advance of up to \$3,000,000.

“ **Contingent Obligation** ” is, for any Person, any direct or indirect liability, contingent or not, of that Person for (i) any indebtedness, lease, dividend, letter of credit or other obligation of another such as an obligation directly or indirectly guaranteed, endorsed, co-made, discounted or sold with recourse by that Person, or for which that Person is directly or indirectly liable; (ii) any obligations for undrawn letters of credit for the account of that Person; and (iii) all obligations from any interest rate, currency or commodity swap agreement, interest rate cap or collar agreement, or other agreement or arrangement designated to protect a Person against fluctuation in interest rates, currency exchange rates or commodity prices; but “Contingent Obligation” does not include endorsements in the ordinary course of business. The amount of a Contingent Obligation is the stated or determined amount of the primary obligation for which the Contingent Obligation is made or, if not determinable, the maximum reasonably anticipated liability for it determined by the Person in good faith; but the amount may not exceed the maximum of the obligations under the guarantee or other support arrangement.

“ **Copyrights** ” are all copyright rights, applications or registrations and like protections in each work or authorship or derivative work, whether published or not (whether or not it is a trade secret) now or later existing, created, acquired or held.

“ **Credit Extension** ” is each Advance, Equipment Advance, Term Loan, Letter of Credit, Non-Formula Equipment Advance, the Cash Management Services, or any other extension of credit by Bank for Borrower’s benefit.

“ **EBITDA Loss** ” means a loss of earnings before interest, taxes, depreciation and amortization. At Bank’s discretion, the EBITDA Loss calculation will be adjusted following extraordinary expenses or income associated with one-time charges such as merger and acquisition expenses, restructuring charges, or sales of assets or discontinued business lines.

“ **Effective Date** ” is the date Bank executes this Agreement.

“ **Equipment** ” is all present and future machinery, equipment, tenant improvements, furniture, fixtures, vehicles, tools, parts and attachments in which Borrower has any interest.

“ **Equipment Advance** ” is defined in Section 2.1.

“ **Equipment Maturity Date** ” is defined in Section 2.1.1.

“ **ERISA** ” is the Employment Retirement Income Security Act of 1974, and its regulations.

“ **Final Payment** ” is a payment (in addition to and not a substitution for the regular monthly payments of principal plus accrued interest) due on the Equipment Maturity Date for such Equipment Advance equal to the original amount of such Equipment Advance (which constituted \$615,016.19) multiplied by the Final Payment Percentage.

“ **Final Payment Percentage** ” is, for each Equipment Advance, 3%.

“ **GAAP** ” is generally accepted accounting principles.

“ **Guarantor** ” is any present or future guarantor of the Obligations.

“ **Indebtedness** ” is (a) indebtedness for borrowed money or the deferred price of property or services, such as reimbursement and other obligations for surety bonds and letters of credit, (b) obligations evidenced by notes, bonds, debentures or similar instruments, (c) capital lease obligations and (d) Contingent Obligations.

“ **Insolvency Proceeding** ” are proceedings by or against any Person under the United States Bankruptcy Code, or any other bankruptcy or insolvency law, including assignments for the benefit of creditors, compositions, extensions generally with its creditors, or proceedings seeking reorganization, arrangement, or other relief.

“ **Intellectual Property** ” is all of Borrower’s:

- (a) Copyrights, Trademarks, Patents, and Mask Works including amendments, renewals, extensions, and all licenses or other rights to use and all license fees and royalties from the use;
- (b) Any trade secrets and any intellectual property rights in computer software and computer software products now or later existing, created, acquired or held;
- (c) All design rights which may be available to Borrower now or later created, acquired or held;

(d) Any claims for damages (past, present or future) for infringement of any of the rights above, with the right, but not the obligation, to sue and collect damages for use or infringement of the intellectual property rights above;

All proceeds and products of the foregoing, including all insurance, indemnity or warranty payments.

“ **Inventory** ” is present and future inventory in which Borrower has any interest, including merchandise, raw materials, parts, supplies, packing and shipping materials, work in process and finished products intended for sale or lease or to be furnished under a contract of service, of every kind and description now or later owned by or in the custody or possession, actual or constructive, of Borrower, including inventory temporarily out of its custody or possession or in transit and including returns on any accounts or other proceeds (including insurance proceeds) from the sale or disposition of any of the foregoing and any documents of title.

“ **Investment** ” is any beneficial ownership of (including stock, partnership interest or other securities) any Person, or any loan, advance or capital contribution to any Person.

“ **Letter of Credit** ” is defined in Section 2.1.3.

“ **Lien** ” is a mortgage, lien, deed of trust, charge, pledge, security interest or other encumbrance.

“ **Loan Documents** ” are, collectively, this Agreement, any note, or notes or guaranties executed by Borrower or Guarantor, and any other present or future agreement between Borrower and/or for the benefit of Bank in connection with this Agreement, all as amended, extended or restated.

“ **Make-Whole Premium** ” is an amount equal to 1% of the prepaid amount of the Non-Formula Equipment Advance.

“ **Mask Works** ” are all mask works or similar rights available for the protection of semiconductor chips, now owned or later acquired.

“ **Material Adverse Change** ” is defined in Section 8.3.

“ **Obligations** ” are debts, principal, interest, Bank Expenses and other amounts Borrower owes Bank now or later, including cash management services, letters of credit and foreign exchange contracts, if any and including interest accruing after Insolvency Proceedings begin and debts, liabilities, or obligations of Borrower assigned to Bank.

“ **Patents** ” are patents, patent applications and like protections, including improvements, divisions, continuations, renewals, reissues, extensions and continuations-in-part of the same.

“ **Permitted Indebtedness** ” is:

- (a) Borrower’s indebtedness to Bank under this Agreement or any other Loan Document;
- (b) Indebtedness existing on the Effective Date and shown on the Schedule;
- (c) Subordinated Debt;
- (d) Indebtedness to trade creditors incurred in the ordinary course of business; and
- (e) Indebtedness secured by Permitted Liens.

“ **Permitted Investments** ” are:

(a) Investments shown on the Schedule and existing on the Effective Date; and

(b) (i) marketable direct obligations issued or unconditionally guaranteed by the United States or its agency or any State maturing within 1 year from its acquisition, (ii) commercial paper maturing no more than 1 year after its creation and having the highest rating from either Standard & Poor’s Corporation or Moody’s Investors Service, Inc., and (iii) Bank’s certificates of deposit issued maturing no more than 1 year after issue.

“ **Permitted Liens** ” are:

(a) Liens existing on the Effective Date and shown on the Schedule or arising under this Agreement or other Loan Documents;

(b) Liens for taxes, fees, assessments or other government charges or levies, either not delinquent or being contested in good faith and for which Borrower maintains adequate reserves on its Books, if they have no priority over any of Bank’s security interests;

(c) Purchase money Liens (i) on Equipment acquired or held by Borrower or its Subsidiaries incurred for financing the acquisition of the Equipment, or (ii) existing on equipment when acquired, if the Lien is confined to the property and improvements and the proceeds of the equipment;

(d) Licenses or sublicenses granted in the ordinary course of Borrower’s business and any interest or title of a licensor or under any license or sublicense, if the licenses and sublicenses permit granting Bank a security interest;

(e) Leases or subleases granted in the ordinary course of Borrower’s business, including in connection with Borrower’s leased premises or leased property;

(f) Liens incurred in the extension, renewal or refinancing of the indebtedness secured by Liens described in (a) through (c), but any extension, renewal or replacement Lien must be limited to the property encumbered by the existing Lien and the principal amount of the indebtedness may not increase.

“ **Person** ” is any individual, sole proprietorship, partnership, limited liability company, joint venture, company association, trust, unincorporated organization, association, corporation, institution, public benefit corporation, firm, joint stock company, estate, entity or government agency.

“ **Prime Rate** ” is Bank’s most recently announced “prime rate,” even if it is not Bank’s lowest rate.

“ **Responsible Officer** ” is each of the Chief Executive Officer, the President, the Chief Financial Officer and the Controller of Borrower.

“ **Revolving Maturity Date** ” is December 28, 2005.

“ **Rights** ”, as applied to the Collateral, means the Borrower’s rights and interests in, and powers with respect to, that Collateral, whatever the nature of those rights, interests and powers and, in any event, including Borrower’s power to transfer rights in such Collateral to Bank.

“ **Schedule** ” is any attached schedule of exceptions.

“ **Subordinated Debt** ” is debt incurred by Borrower subordinated to Borrower’s indebtedness owed to Bank and which is reflected in a written agreement in a manner and form acceptable to Bank and approved by Bank in writing.

“ **Subsidiary** ” is for any Person, or any other business entity of which more than 50% of the voting stock or other equity interests is owned or controlled, directly or indirectly, by the Person or one or more Affiliates of the Person.

“ **Tangible Net Worth** ” is, on any date, the consolidated total assets of Borrower and its Subsidiaries minus, (i) any amounts attributable to (a) goodwill, (b) intangible items such as unamortized debt discount and expense, patents, trade and service marks and names, copyrights and research and development expenses except prepaid expenses, and (c) reserves not already deducted from assets, and (ii) Total Liabilities.

“ **Term Loan Conversion Date** ” means the date on which Advances are converted into a Term Loan pursuant to Section 2.1.2 hereof.

“ **Total Liabilities** ” is on any day, obligations that should, under GAAP, be classified as liabilities on Borrower’s consolidated balance sheet, including all Indebtedness, and current portion Subordinated Debt allowed to be paid, but excluding all other Subordinated Debt.

“ **Trademarks** ” are trademark and servicemark rights, registered or not, applications to register and registrations and like protections, and the entire goodwill of the business of Assignor connected with the trademarks.

BORROWER:

DRUGSTORE.COM, INC.

By: /s/ Robert Barton

Title: CFO

BANK:

SILICON VALLEY BANK

By: /s/ Annette Sager

Title: Vice President

Effective Date: December 29, 2004

EXHIBIT A

The Collateral consists of all of Borrower's right, title and interest in and to the following whether owned now or hereafter arising and whether the Borrower has rights now or hereafter has rights therein and wherever located:

All goods and equipment now owned or hereafter acquired, including, without limitation, all machinery, fixtures, vehicles (including motor vehicles and trailers), and any interest in any of the foregoing, and all attachments, accessories, accessions, replacements, substitutions, additions, and improvements to any of the foregoing, wherever located;

All inventory, now owned or hereafter acquired, including, without limitation, all merchandise, raw materials, parts, supplies, packing and shipping materials, work in process and finished products including such inventory as is temporarily out of Borrower's custody or possession or in transit and including any returns upon any accounts or other proceeds, including insurance proceeds, resulting from the sale or disposition of any of the foregoing and any documents of title representing any of the above;

All contract rights and general intangibles (as such definitions may be amended from time to time according to the Code), now owned or hereafter acquired, including, without limitation, goodwill, trademarks, servicemarks, trade styles, trade names, patents, patent applications, leases, license agreements, franchise agreements, blueprints, drawings, purchase orders, customer lists, route lists, infringements, claims, computer programs, computer discs, computer tapes, literature, reports, catalogs, design rights, income tax refunds, payments of insurance and rights to payment of any kind;

All now existing and hereafter arising accounts, contract rights, royalties, license rights and all other forms of obligations owing to Borrower arising out of the sale or lease of goods, the licensing of technology or the rendering of services by Borrower (as such definitions may be amended from time to time according to the Code) whether or not earned by performance, and any and all credit insurance, insurance (including refund) claims and proceeds, guaranties, and other security therefor, as well as all merchandise returned to or reclaimed by Borrower;

All documents, cash, deposit accounts, securities, securities entitlements, securities accounts, investment property, financial assets, letters of credit, letter of credit rights, certificates of deposit, instruments and chattel paper and electronic chattel paper now owned or hereafter acquired and Borrower's Books relating to the foregoing; and

All Borrower's Books relating to the foregoing and any and all claims, rights and interests in any of the above and all substitutions for, additions and accessions to and proceeds thereof.

Notwithstanding the foregoing, the Collateral shall not include any copyrights, patents, trademarks, servicemarks and applications therefor, now owned or hereafter acquired, or any claims for damages by way of any past, present and future infringement of any of the foregoing (collectively, the "Intellectual Property"); provided, however, that the Collateral shall include all accounts and general intangibles that consist of rights to payment and proceeds from the sale, licensing or disposition of all or any part, or rights in, the foregoing (the "Rights to Payment"). Notwithstanding the foregoing, if a judicial authority (including a U.S. Bankruptcy Court) holds that a security interest in the underlying Intellectual Property is necessary to have a security interest in the Rights to Payment, then the Collateral shall automatically, and effective as of the Closing Date, include the Intellectual Property to the extent necessary to permit perfection of Bank's security interest in the Rights to Payment.

Borrower and Bank are parties to that certain negative pledge arrangement, whereby Borrower, in connection with Bank's loan or loans to Borrower, has agreed, among other things, not to sell, transfer, assign, mortgage, pledge, lease grant a security interest in, or encumber any of its Intellectual Property, without Bank's prior written consent.

EXHIBIT B

L OAN P AYMENT /A DVANCE R EQUEST F ORM
D EADLINE FOR SAME DAY PROCESSING IS 12:00 P.S.T.

Fax To: _____ **Date:** _____

L OAN P AYMENT :

DRUGSTORE.COM, INC. (Borrower)

From Account # _____ To Account # _____
(Deposit Account #) (Loan Account #)

Principal \$ _____ and/or Interest \$ _____

All Borrower's representation and warranties in the Amended and Restated Loan and Security Agreement are true, correct and complete in all material respects up to and including the date of the transfer request for a loan payment, but those representations and warranties expressly referring to another date shall be true, correct and complete in all material respects as of that date:

Authorized Signature: _____ **Phone Number:** _____

L OAN A DVANCE :

Complete *Outgoing Wire Request* section below if all or a portion of the funds from this loan advance are for an outgoing wire.

From Account # _____ To Account # _____
(Loan Account #) (Deposit Account #)

Amount of Advance \$ _____

All Borrower's representation and warranties in the Amended and Restated Loan and Security Agreement are true, correct and complete in all material respects up to and including the date of the transfer request for an advance, but those representations and warranties expressly referring to another date shall be true, correct and complete in all material respects as of that date:

Authorized Signature: _____ **Phone Number:** _____

O UTGOING W IRE R EQUEST

Complete only if all or a portion of funds from the *loan advance* above are to be wired.

Deadline for same day processing is 12:00pm, P.S.T.

Beneficiary Name: _____ Amount of Wire: \$ _____

Beneficiary Bank: _____ Account Number: _____

City and State: _____

Beneficiary Bank Transit (ABA) #: _____ Beneficiary Bank Code (Swift, Sort, Chip, etc.): _____
(For International Wire Only)

Intermediary Bank: _____ Transit (ABA) #: _____

For Further Credit to: _____

Special Instruction: _____

By signing below, I (we) acknowledge and agree that my (our) funds transfer request shall be processed in accordance with and subject to the terms and conditions set forth in the agreements(s) covering funds transfer service(s), which agreements(s) were previously received and executed by me (us).

Authorized Signature: _____ 2nd Signature (If Required): _____

Print Name/Title: _____ Print Name/Title: _____

Telephone # _____ Telephone # _____

**EXHIBIT C
COMPLIANCE CERTIFICATE**

TO: SILICON VALLEY BANK
3003 Tasman Drive
Santa Clara, CA 95054

FROM: DRUGSTORE.COM, INC.

The undersigned Responsible Officer of DRUGSTORE.COM, INC. (“Borrower”) certifies that under the terms and conditions of the Amended and Restated Loan and Security Agreement between Borrower and Bank (the “Agreement”), (i) Borrower is in complete compliance for the period ending _____ with all required covenants except as noted below and (ii) all representations and warranties in the Agreement are true and correct in all material respects on this date. In addition, the undersigned certifies that (i) Borrower and each Subsidiary has timely filed all required tax returns and paid, or made adequate provision to pay, all material taxes, except those being contested in good faith with adequate reserves under GAAP and (ii) no liens has been levied or claims made against Borrower or any of its Subsidiaries relating to unpaid employee payroll or benefits which Borrower has not previously notified in writing to Bank. In addition, the undersigned certifies that Borrower, and each Subsidiary, has timely filed all required tax returns and paid, or made adequate provision to pay, all material taxes, except those being contested in good faith with adequate reserves under GAAP. Attached are the required documents supporting the certification. The Officer certifies that these are prepared in accordance with Generally Accepted Accounting Principles (GAAP) consistently applied from one period to the next except as explained in an accompanying letter or footnotes. The Responsible Officer acknowledges that no borrowings may be requested at any time or date of determination that Borrower is not in compliance with any of the terms of the Agreement, and that compliance is determined not just at the date this certificate is delivered.

Please indicate compliance status by circling Yes/No under “Complies” column.

<u>Reporting Covenant</u>	<u>Required</u>	<u>Complies</u>
Monthly financial statements + CC	Monthly within 30 days	Yes No
Annual (Audited)	FYE within 120 days	Yes No
10-Q, 10-K and 8-K	Within 5 days after filing with SEC	Yes No

<u>Financial Covenant</u>	<u>Required</u>	<u>Actual</u>	<u>Complies</u>
Maximum Trailing 3 Mo. EBITDA Loss	\$3,500,000	\$ _____	Yes No
Minimum Cash	\$15,000,000	\$ _____	Yes No

Borrower only has deposit accounts located at the following institutions: _____.

Comments Regarding Exceptions: See Attached.

BANK USE ONLY

Sincerely,
DRUGSTORE.COM, INC.

SIGNATURE

TITLE

DATE

Received by: _____

AUTHORIZED SIGNER

Date:

Verified: _____

AUTHORIZED SIGNER

Date:

Compliance Status: Yes No

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 quarterly 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 quarterly 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 financial 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 12, 2006

/s/ Dawn G. Lepore

President, Chief Executive Officer and
Chairman of the Board

CERTIFICATIONS

I, Robert A. Barton, 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 quarterly 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 quarterly 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 financial 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 12, 2006

/s/ Robert A. Barton

Vice President, Chief Financial Officer
and Treasurer

**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 2, 2006, 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 12, 2006

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.

**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 2, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Robert A. Barton, Vice President, and Chief Financial 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 A. Barton

Vice President, Chief Financial Officer
and Treasurer

May 12, 2006

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.