

DRUGSTORE COM INC

FORM 10-K/A (Amended Annual Report)

Filed 09/10/08 for the Period Ending 12/30/07

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|-------------|---|
| Address | 411 108TH AVE. NE SUITE 1400 BELLEVUE, WA 98004 |
| Telephone | 4253723200 |
| CIK | 0001086467 |
| Symbol | DSCM |
| SIC Code | 5912 - Drug Stores and Proprietary Stores |
| Industry | Retail (Drugs) |
| Sector | Services |
| Fiscal Year | 12/31 |

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K/A

(Mark one)
 ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 30, 2007

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: 0-26137

drugstore.com, inc.

(Exact Name of Registrant as Specified in its Charter)

Delaware

(State or Other Jurisdiction of Incorporation or Organization)

04-3416255

(I.R.S. Employer Identification No.)

411 108th Avenue NE, Suite 1400

Bellevue, Washington 98004

(Address of Principal Executive Offices)

(425) 372-3200

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class

Common Stock, par value \$0.0001 per share

Name of Each Market on Which Listed

NASDAQ Stock Market LLC
(NASDAQ Global Market)

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

The aggregate market value of common stock held by non-affiliates of the registrant was \$260,161,542 as of July 1, 2007, the last business day of the registrant's most recently completed second fiscal quarter.

As of March 7, 2008, the number of shares of the registrant's common stock outstanding was 94,574,844.

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III of this annual report, to the extent not set forth in this annual report, is incorporated by reference from the registrant's definitive proxy statement relating to the registrant's annual meeting of stockholders to be held on June 12, 2008, which definitive proxy statement will be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this annual report relates.

drugstore.com, inc. is filing this Amendment No. 1 to its Annual Report on Form 10-K for the fiscal year ended December 30, 2007, in order to revise the relevant portions of Part III, Item 11 (previously incorporated by reference to its definitive proxy statement filed April 18, 2008) to provide certain required valuations of its post-termination compensation arrangements with its executives as of December 30, 2007.

Special Note Regarding Forward-Looking Statements

This annual report on Form 10-K and the documents incorporated into this annual report by reference contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 based on our expectations, estimates and projections as of the date of this filing. Actual results may differ materially from those expressed in forward-looking statements. All statements made in this annual 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 “expects,” “believes,” “targets,” “may,” “will,” “outlook,” “continue,” “remain,” “could,” “would,” “should,” and similar expressions or any variation of such 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 and other risks and uncertainties that could cause our actual results to differ significantly from management’s expectations are described in the following discussion and in the section entitled “Risk Factors” in Part I, Item 1A of this annual report. You should not rely on a forward-looking statement as representing our views as of any date other than the date on which we made the statement. We expressly disclaim any intent or obligation to update any forward-looking statement after the date on which we make it.

ITEM 11. EXECUTIVE COMPENSATION

Post-Employment Compensation

Post-Employment Agreements with Executive Officers

We have severance or change-of-control agreements with our chief executive officer and our chief financial officer, as discussed below. Our 1998 Stock Plan does not provide for automatic acceleration of vesting in the event of a change of control, though it authorizes the plan administrator to provide for such terms on a case-by-case basis. As discussed above, the proposed 2008 Equity Incentive Plan authorizes the plan administrator to determine how awards are treated in the event of a change of control, but specifically provides for acceleration of vesting in the event awards are not assumed or substituted by the successor corporation.

Lepore Severance and Change-of-Control Agreement

Under the terms of our offer letter to Ms. Lepore, as amended in December 2006, under certain circumstances, we will make payments and grant rights to her in connection with the termination of her employment or a change of control, as follows:

If we terminate Ms. Lepore’s employment without cause or if she resigns her employment for good reason, she will receive:

- a severance package that includes one year of annual salary and one year of target bonus at the levels in effect at the time of such termination, payable in a lump sum at Ms. Lepore’s option; and
- twelve additional months of vesting credit under any options she holds for which vesting is based exclusively on her continued service to us.

Ms. Lepore’s receipt of these benefits will be subject to her compliance with our confidentiality agreement and her execution of a release of claims in the form customarily used by us in connection with the termination of an executive officer’s employment. Had we terminated Ms. Lepore’s employment without cause or had she resigned for good reason on December 30, 2007, under this provision of her offer letter, we would have made payments to her totaling \$705,000.00. In addition, Ms. Lepore’s options would have vested and become fully exercisable with respect to 1,142,858 of the remaining shares subject thereto, providing for a gain on exercise equal to approximately \$141,714.

If Ms. Lepore's employment is terminated for any reason other than death or permanent and total disability, she will have a period of up to one year in which to exercise her vested options, provided that any vested options not exercised on or prior to her termination date will terminate as follows: 25% will terminate three months following her termination, and an additional 25% will terminate at the end of each three-month period thereafter.

If there is a change of control, all of Ms. Lepore's options will immediately become fully vested and exercisable. In the event that the benefits provided to Ms. Lepore in connection with a change of control constitute "parachute payments" within the meaning of Section 280G of the Internal Revenue Code, we may reduce such benefits to the extent necessary for such benefits not to be subject to the excise tax imposed by Section 4999 of the Internal Revenue Code. Had a change of control occurred on December 30, 2007, Ms. Lepore's options would have vested and become fully exercisable with respect to all of the remaining 3,142,858 shares subject thereto, providing for a gain on exercise equal to approximately \$761,714.

For purposes of Ms. Lepore's offer letter:

- "cause" means
 - Ms. Lepore's willful or negligent failure to comply with the lawful directions of our board of directors;
 - gross negligence or willful misconduct in the performance of her duties to us;
 - commission of any act of fraud that results in an injury to us (other than a de minimus injury); or
 - misappropriation of our material property to our material detriment.
- "good reason" means
 - our failure to pay or to cause to be paid Ms. Lepore's annual salary or any earned annual target bonus when due;
 - the substantial reduction of Ms. Lepore's annual salary without her consent;
 - the substantial reduction of Ms. Lepore's target bonus range unaccompanied by any corresponding upward adjustment in any other form of incentive compensation without her consent;
 - a material diminution in Ms. Lepore's authority, responsibilities, duties, or reporting relationships as our president and chief executive officer (but not as Chairman of the Board) without her consent;
 - relocation of Ms. Lepore's primary work place (currently Bellevue, Washington) to a location more than thirty-five (35) miles from our current location without her consent;
 - our failure to nominate Ms. Lepore to serve as a director at each annual stockholder meeting while she is serving as our president and chief executive officer; or
 - a material reduction in the kind or level of the benefits or perquisites for which Ms. Lepore is eligible without her consent, unless the reduction is applicable to substantially all of our other executive officers;

provided that the events above shall constitute good reason only if we fail to cure such event within a reasonable period of time (not to exceed fifteen (15) business days) after receipt of written notice of the event; provided, further, that "good reason" shall cease to exist for an event on the 90th day following its occurrence, unless Ms. Lepore has given us written notice of the event prior to such date.

- "change of control" means
 - the sale, lease, or other disposition of all or substantially all of our assets;

- the acquisition of beneficial ownership of more than 50% of the total voting power represented by our then-outstanding voting securities by any person or group of related persons (other than by any of our affiliates or any benefit plan sponsored or maintained by us or any of our subsidiaries);
- the acquisition of us by another entity by means of merger, consolidation, or similar transaction after which our stockholders immediately prior to the occurrence of such merger, consolidation, or similar transaction hold less than 50% of the total voting power of the surviving controlling entity; or
- a change in the composition of our board of directors such that during any period of two (2) consecutive years, individuals who at the beginning of such period constituted our board of directors (together with any new directors whose election by such board of directors or whose nomination for election by our stockholders was approved by a vote of a majority of our directors then in office, who were either directors at the beginning of such period or whose election or nomination for election was previously so approved) cease for any reason to constitute a majority of our board of directors then in office; provided that a reincorporation shall not be considered a change of control.

du Pont Severance and Change-of-Control Agreement

We entered into a change of control agreement with Mr. du Pont, pursuant to which the option granted to him in connection with his initial employment will vest in full in the event that we terminate his employment without cause or he terminates his employment for good reason within one year of a change of control of drugstore.com. In addition, following any such termination, he will have a period of up to six months in which to exercise his options, provided that any options not exercised on or prior to the date of his termination of employment will terminate as follows: 50% will terminate three months after his termination, and the remaining 50% will terminate six months after his termination. Had we terminated Mr. du Pont's employment without cause or had he terminated his employment for good reason on December 30, 2007, and had such date been within one year of a change of control, his option would have vested and have become immediately exercisable with respect to all of the remaining 600,000 shares subject thereto, providing for a gain on exercise equal to \$426,000.

For purposes of the change of control agreement:

- "change of control" means:
 - reorganization, exchange of securities, merger or consolidation involving drugstore.com, unless immediately following such transaction;
 - the beneficial owners of our outstanding common stock immediately prior to such transaction continue to hold more than 50% of the common stock and the combined voting power of the surviving in substantially the same proportion they held immediately prior to such transaction, and
 - our incumbent directors prior to the transaction continue to represent at least a majority of the board of directors of the surviving corporation;
 - sale, lease, exchange or other transfer of all or substantially all of our assets other than a transfer to one of our majority-owned subsidiaries; or
 - acquisition by a person of a majority or more of our outstanding voting securities.
- "cause" means:
 - A clear refusal to carry out any of his material lawful duties or any directions of the board, all reasonably consistent with the duties of his position, provided Mr. du Pont has been given reasonable notice and opportunity to correct any such failure;
 - Violation of a state or federal criminal law involving the commission of a crime against us or any of our subsidiaries;
 - Deception, fraud, misrepresentation or dishonesty by Mr. du Pont, or any incident materially compromising his reputation or ability to represent us with investors, customers or the public; or
 - Unauthorized use or disclosure of confidential information or trade secrets.

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- “good reason” means any of the following uncured events:
 - The assignment of any duties materially inconsistent with his title, position, authority, duties or responsibilities held, exercised and assigned at anytime during the 90-day period immediately preceding the change of control or any other action by us that results in a material diminution in such title, position, authority, duties or responsibilities;
 - Our requiring Mr. du Pont to be based at any office or location other than the office or location where he was based immediately prior to the change of control or at any other place within a 35-mile radius of such location (except for reasonably required travel); or,
 - Any other material violation of any provision of the change of control agreement by us.

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES.

- (a) The following exhibits are filed as a part of this amendment to annual report on Form 10-K/A:

| <u>Exhibit No.</u> | <u>Description</u> |
|--------------------|---|
| 31.1 | Certification of Dawn G. Lepore, Chairman of Board, President and Chief Executive Officer of drugstore.com, inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Robert P. Potter, Vice President and Chief Accounting Officer of drugstore.com, inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Dawn G. Lepore, Chairman of Board, President and Chief Executive Officer of drugstore.com, inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Robert P. Potter, Vice President and Chief Accounting Officer of drugstore.com, inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

CERTIFICATION

I, Dawn G. Lepore, certify that:

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

/s/ Dawn G. Lepore

Dawn G. Lepore
President, Chief Executive Officer and Chairman
of the Board

September 10, 2008

CERTIFICATIONS

I, Robert P. Potter, certify that:

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

/s/ Robert P. Potter

Robert P. Potter
Vice President and Chief Accounting Officer

September 10, 2008

**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 Amendment to Annual Report on Form 10-K/A of drugstore.com, inc. (the "Company") for the period ending December 30, 2007, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Dawn G. Lepore, Chief Executive 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 result of operations of the Company.

/s/ Dawn G. Lepore

Dawn G. Lepore
President, Chief Executive Officer and Chairman
of the Board

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.

September 10, 2008

**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 Amendment to Annual Report on Form 10-K/A of drugstore.com, inc. (the "Company") for the period ending December 30, 2007, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Robert P. Potter, Vice President and Chief Accounting Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Robert P. Potter

Robert P. Potter
Vice President and Chief Accounting Officer

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.

September 10, 2008