TRAVELZOO INC
Form 10-Q
October 26, 2012
Table of Contents

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

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

or

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

For the transition period from to .

Commission File No.: 000-50171

TRAVELZOO INC.
(Exact name of registrant as specified in its charter)

DELAWARE	36-4415727
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer identification no.)
590 Madison Avenue, 37th Floor New York, New York	10,022
(Address of principal executive offices)	(Zip code)

Registrant's telephone number, including area code: (212) 484-4900

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 x No ¨

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

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 x
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	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 x

The number of shares of Travelzoo common stock outstanding as of October 25, 2012 was 15,800,755 shares.

Table of Contents

TRAVELZOO INC.
Table of Contents

Table of Contents

PART I—FINANCIAL INFORMATION
Item 1. Financial Statements
TRAVELZOO INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In thousands, except par value)

	September 30, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$57,634	$38,744
Accounts receivable, less allowance for doubtful accounts of $450 and $400 as of September 30, 2012 and December 31, 2011, respectively	15,440	13,340
Income tax receivable	10,052	3,625
Deposits	381	278
Prepaid expenses and other current assets	2,757	2,123
Deferred tax assets	1,356	1,754
Total current assets	87,620	59,864
Deposits, less current portion	1,068	776
Deferred tax assets, less current portion	357	344
Restricted cash	3,122	3,103
Property and equipment, net	4,007	3,557
Intangible assets, net	440	704
Total assets	$96,614	$68,348
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$23,314	$21,731
Accrued expenses	12,619	6,311
Deferred revenue	2,506	2,168
Income tax payable	—	279
Deferred rent	287	114
Total current liabilities	38,726	30,603
Long-term tax liabilities	9,874	2,225
Deferred rent, less current portion	831	761
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.01 par value per share (5,000 shares authorized; none issued)	—	—
Common stock, $0.01 par value (40,000 shares authorized; 15,801 shares issued and outstanding as of September 30, 2012 and 16,462 shares issued and 15,962 shares outstanding as of December 31, 2011)	163	164
Treasury stock (at cost, 0 and 500 shares at September 30, 2012 and December 31, 2011)	—	(15,123)
Additional paid-in capital	8,556	7,656
Retained earnings	39,192	43,484
Accumulated other comprehensive loss	(728)	(1,422)
Total stockholders' equity	47,183	34,759
Total liabilities and stockholders' equity	$96,614	$68,348

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

TRAVELZOO INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues	$35,447	$38,661	$114,140	$113,186
Cost of revenues	3,989	4,221	11,672	9,603
Gross profit	31,458	34,440	102,468	103,583
Operating expenses:				
Sales and marketing	17,427	16,737	49,753	51,569
General and administrative	9,836	8,478	28,583	25,167
Unexchanged promotional merger shares	—	—	3,000	20,000
Total operating expenses	27,263	25,215	81,336	96,736
Income from operations	4,195	9,225	21,132	6,847
Other income	135	—	218	105
Income before income taxes	4,330	9,225	21,350	6,952
Income taxes	896	3,298	6,908	10,061
Net income (loss)	$3,434	$5,927	$14,442	$(3,109)
Basic net income (loss) per share	$0.22	$0.36	$0.91	$(0.19)
Diluted net income (loss) per share	$0.22	$0.36	$0.90	$(0.19)
Shares used in computing basic net income (loss) per share	15,884	16,396	15,935	16,434
Shares used in computing diluted net income (loss) per share	15,922	16,504	16,041	16,434

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

TRAVELZOO INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited)
(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income (loss)	$3,434	$5,927	$14,442	$(3,109)
Other comprehensive income (loss):				
Foreign currency translation adjustment	756	(471)	694	(269)
Total comprehensive income (loss)	$4,190	$5,456	$15,136	$(3,378)

Table of Contents

TRAVELZOO INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	Nine Months Ended September 30, 2012	2011
Cash flows from operating activities:		
Net income (loss)	$14,442	$(3,109)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,856	2,054
Deferred income tax	(3)	209
Stock-based compensation	900	562
Provision for losses on accounts receivable	116	(25)
Tax benefit of stock option exercise	—	(268)
Net foreign currency effect	(6)	24
Changes in operating assets and liabilities:		
Accounts receivable	(2,069)	(722)
Deposits	(382)	(568)
Income tax receivable	1,819	(2,031)
Prepaid expenses and other current assets	(241)	(771)
Accounts payable	1,189	7,454
Accrued expenses	6,198	4,992
Deferred revenue	323	268
Deferred rent	21	179
Income tax payable	(284)	(353)
Other non-current liabilities	(190)	659
Net cash provided by operating activities	23,689	8,554
Cash flows from investing activities:		
Purchases of property and equipment	(2,046)	(1,902)
Net cash used in investing activities	(2,046)	(1,902)
Cash flows from financing activities:		
Repurchase of common stock	(3,611)	(15,124)
Proceeds from exercise of stock options	—	40
Tax benefit of stock option exercise	—	268
Net cash used in financing activities	(3,611)	(14,816)
Effect of exchange rate changes on cash and cash equivalents	858	(587)
Net increase (decrease) in cash and cash equivalents	18,890	(8,751)
Cash and cash equivalents at beginning of period	38,744	41,184
Cash and cash equivalents at end of period	$57,634	$32,433
Supplemental disclosure of cash flow information:		
Cash paid (refunded) for income taxes, net	$5,568	$11,572

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

TRAVELZOO INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1: The Company and Basis of Presentation

Travelzoo Inc. (the “Company” or “Travelzoo”) is a global Internet media company. We inform over 25 million subscribers in North America, Europe and Asia Pacific, as well as millions of website users, about the best travel, entertainment and local deals available from thousands of companies. Our deal experts source, research and test-book offers, recommending only those that meet Travelzoo’s rigorous quality standards. We provide travel companies, entertainment companies, and local businesses with a fast, flexible, and cost effective way to reach millions of consumers. Our revenues are generated primarily from advertising fees. In Asia Pacific, the Travelzoo business is operated by Travelzoo (Asia) Ltd. and Travelzoo Japan K.K. under a license agreement with Travelzoo Inc.

Our publications and products include the Travelzoo websites (www.travelzoo.com, www.travelzoo.ca, www.travelzoo.co.uk, www.travelzoo.de, www.travelzoo.es, www.travelzoo.fr, among others), the Travelzoo Top 20 e-mail newsletter, the Newsflash e-mail alert service, the SuperSearch pay-per-click travel search tool, and the Travelzoo Network, a network of third-party websites that list travel deals published by Travelzoo. We also operate Fly.com, a travel search engine that allows users to quickly and easily find the best prices on flights from hundreds of airlines and online travel agencies. Recently, we launched Local Deals and Getaways, new services that allow our subscribers to purchase vouchers for deals from local businesses such as spas, hotels and restaurants through the Travelzoo website. Vouchers are redeemable at the local businesses during the promotional period. We receive a percentage of the face value of the voucher from the local businesses.

Since November 1, 2009, the Travelzoo websites in Asia Pacific (cn.travelzoo.com, www.travelzoo.co.jp, www.travelzoo.com.au, www.travelzoo.com.hk, www.travelzoo.com.tw, among others), the Travelzoo Top 20 e-mail newsletters in Asia Pacific and the Newsflash e-mail alert service in Asia Pacific have been published by Travelzoo (Asia) Limited and Travelzoo Japan K.K., wholly owned subsidiaries of Azzurro Capital Inc., under a license agreement with the Company. There is a reciprocal revenue-sharing agreement among the entities operating the Travelzoo business in Asia Pacific and the Company related to cross-selling audiences, channels and offers.

Travelzoo is controlled by Ralph Bartel, who held beneficially approximately 53.8% of the outstanding shares as of October 25, 2012.

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company in accordance with the rules and regulations of the U.S. Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted in accordance with such rules and regulations. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position of the Company, and its results of operations and cash flows. These condensed consolidated financial statements should be read in conjunction with the Company’s audited consolidated financial statements and related notes as of and for the year ended December 31, 2011, included in the Company’s Form 10-K filed with the SEC on February 21, 2012.

The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. All foreign subsidiaries use the local currency of their respective countries as their functional currency. Assets and liabilities are translated into U.S. dollars at exchange rates prevailing at the balance sheet dates. Revenues, costs and expenses are translated into U.S. dollars at average exchange rates for the period.

The results of operations for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012 or any other future period, and the Company makes no representations related thereto.

The Company was formed as a result of a combination and merger of entities founded by the Company’s majority stockholder, Ralph Bartel. In 1998, Mr. Bartel founded Travelzoo.com Corporation, a Bahamas corporation, which issued 5,155,874 shares via the Internet to approximately 700,000 “Netsurfer stockholders” for no cash consideration, but subject to certain conditions as referred to below. In 1998, Mr. Bartel also founded Silicon Channels Corporation, a California corporation, to operate the Travelzoo website. During 2001, Travelzoo Inc. was formed as a subsidiary of Travelzoo.com Corporation, and Mr. Bartel contributed all of the outstanding shares of Silicon Channels Corporation to Travelzoo Inc. in

Table of Contents

exchange for 8,129,273 shares of Travelzoo Inc. and options to acquire an additional 2,158,349 shares at $1.00. Mr. Bartel exercised these options in January 2009.

In April 2002, Travelzoo.com Corporation was merged into Travelzoo Inc. Under and subject to the terms of the merger agreement, holders of promotional shares of Travelzoo.com Corporation (“Netsurfers”) who established that they had satisfied certain prerequisite qualifications were allowed a period of 2 years following the effective date of the merger to receive 1 share of Travelzoo Inc. in exchange for each share of common stock of Travelzoo.com Corporation. The records of Travelzoo.com Corporation showed that, assuming all of the shares applied for by the Netsurfer stockholders were validly issued, there were 11,295,874 shares of Travelzoo.com Corporation outstanding. As of April 25, 2004, two years following the effective date of the merger, 7,180,342 shares of Travelzoo.com Corporation had been exchanged for shares of Travelzoo Inc. Prior to that date, the remaining shares were also included in the issued and outstanding common stock of Travelzoo Inc. and included in the calculation of basic and diluted earnings per share. After April 25, 2004, the Company ceased issuing shares to the former stockholders of Travelzoo.com Corporation, and no additional shares are reserved for issuance to any former stockholders, because their right to receive shares has now expired. On April 25, 2004, the number of shares reported as outstanding was reduced from 19,425,147 to 15,309,615 to reflect actual shares issued as of the expiration date. Earnings per share calculations reflect this reduction of the number of shares reported as outstanding. As of September 30, 2012, there were 15,800,755 shares of common stock outstanding.

On April 21, 2011, the Company entered into an agreement with the State of Delaware resolving all claims relating to an unclaimed property review which began in 2010. The primary issue raised in the preliminary findings from the review, received by the Company on April 12, 2011, concerned the shares of Travelzoo which have not been claimed by former Netsurfer stockholders of Travelzoo.com as discussed in the preceding paragraph. In the preliminary findings under the unclaimed property review, up to 3.0 million shares were identified as “demandable” under Delaware escheat laws. While the Company continues to take the position that such shares were a promotional incentive and were issuable only to persons who establish their eligibility as stockholders, the Company determined that it was in its best interest to promptly resolve all claims relating to the unclaimed property review. The Company made a $20.0 million cash payment to the State of Delaware on April 27, 2011 and received a complete release of those claims.

Since March 2012, the Company became subject to unclaimed property reviews by most of the other states in the U.S. The auditing firm representing these States in the reviews has presented to the Company preliminary findings which relate primarily to the unexchanged promotional merger shares that were not covered by the settlement and release by the State of Delaware. During the three months ended March 31, 2012, the Company recorded a $3.0 million charge related to this unexchanged promotional merger shares contingency. While the Company believes it has meritorious defenses regarding the applicability of escheat rights related to this unexchanged promotional merger shares contingency, the ultimate resolution of this matter may take longer than one year to resolve. If the claims for all of the additional shares referred to in the preliminary findings were upheld in full, based on the closing price of the Company’s shares at the end of September 2012, the cost to the Company would be approximately $23.2 million in excess of the amount accrued, plus any interest or penalty which might be applicable. In addition, the total amount of exposure of this contingency is dependent upon the manner in which each state applies its unclaimed property laws. The Company is not able to predict the ultimate amount or outcome of any current or future claims which have been or might be asserted relating to the unissued shares.

The Company intends to continue to challenge the applicability of escheat rights, in that, among other reasons, the shares of the predecessor Bahamas corporation were offered for free as part of a promotional incentive program to qualified individuals. There were certain conditions applicable to the issuance of shares to the Netsurfer stockholders, including requirements that (i) they be at least 18 years of age, (ii) they be residents of the U.S. or Canada, and (iii) they not apply for shares more than once. The Netsurfer stockholders were advised that failure to comply could result in cancellation of their shares in Travelzoo.com Corporation. Travelzoo.com Corporation was not able to verify that the applicants met the requirements referred to above at the time of their applications for issuance of shares, and the remaining Netsurfer stockholders who have not qualified to receive shares in the Company, or who have not participated in the cash payments program referred to below, have not demonstrated their actual compliance with the conditions to the issuance of shares by Travelzoo.com Corporation. The Company does not know how many of the requests for shares originally received by Travelzoo.com Corporation in 1998 were valid, but the Company believes that only a portion of such requests were valid. In response to the pending reviews referred to above, and in response to other persons claiming to be former stockholders of Travelzoo.com Corporation, the Company intends to assert that the claimant must establish that the original Netsurfer stockholders complied with the conditions to issuance of their shares.

The Company is continuing its program under which it makes cash payments to people who establish that they satisfy the conditions to receive shares of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares of Travelzoo Inc. within the required time period. The accompanying condensed consolidated financial statements include a

Table of Contents

charge in general and administrative expenses of $2,000 and $24,000 for these cash payments for the three months and nine months ended September 30, 2012.

The total cost of this program is not reliably estimable because it is based on the ultimate number of valid requests received and future levels of the Company’s common stock price, and would be affected by any settlement of the pending reviews referred to above. The Company’s common stock price affects the liability because the amount of cash payments under the program is based in part on the recent level of the stock price at the date valid requests are received. As noted above, in order to receive payment under the program, a person is required to establish that such person validly held shares in Travelzoo.com Corporation.

In July 2012, the Company announced a stock repurchase program authorizing the repurchase of up to 1,000,000 shares of the Company’s outstanding common stock. As of September 30, 2012, the Company has purchased 161,000 shares of common stock for an aggregate purchase price of $3.6 million under the stock repurchase program.

Note 2: Net Income (Loss) Per Share

Basic net income (loss) per share is computed using the weighted-average number of common shares outstanding for the period. Diluted net income (loss) per share is computed by adjusting the weighted-average number of common shares outstanding for the effect of dilutive potential common shares outstanding during the period. Potential common shares included in the diluted calculation consist of incremental shares issuable upon the exercise of outstanding stock options calculated using the treasury stock method.

The following table sets forth the calculation of basic and diluted net income (loss) per share (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Basic net income (loss) per share:				
Net income (loss)	$3,434	$5,927	$14,442	$(3,109)
Weighted average common shares	15,884	16,396	15,935	16,434
Basic net income (loss) per share	$0.22	$0.36	$0.91	$(0.19)
Diluted net income (loss) per share:				
Net income (loss)	$3,434	$5,927	$14,442	$(3,109)
Weighted average common shares	15,884	16,396	15,935	16,434
Effect of dilutive securities: stock options	38	108	106	—
Diluted weighted average common shares	15,922	16,504	16,041	16,434
Diluted net income (loss) per share	$0.22	$0.36	$0.90	$(0.19)

For the three months ended September 30, 2012, options to purchase 100,000 shares of common stock were not included in the computation of diluted net income per share because the effect would have been anti-dilutive.

For the nine months ended September 30, 2012, options to purchase 100,000 shares of common stock were not included in the computation of diluted net income per share because the effect would have been anti-dilutive. For the nine months ended September 30, 2011, options to purchase 300,000 shares of common stock were not included in the computation of diluted net income (loss) per share because the effect would have been anti-dilutive.

Note 3: Financial Instruments

At September 30, 2012, restricted cash consisted primarily of a certificate of deposit for $875,000 serving as collateral for a standby letter of credit for the security deposit under the lease of our corporate headquarters and a $2.2 million deposit with our bank in the U.K. for our merchant account. Cash equivalents consist of highly liquid investments with remaining maturities of 3 months or less on the date of purchase held in money market funds. The Company believes that the carrying amounts of these financial assets are a reasonable estimate of their fair value and are categorized as Level 1.

9

Table of Contents

The fair value of these financial assets was determined using the following inputs at September 30, 2012 and December 31, 2011 (in thousands):

	Fair Value Measurements at Reporting Date Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Balance at September 30, 2012				
Money market funds	$13,186	$ 13,186	$—	$—
Total	$13,186	$ 13,186	$—	$—
Balance at December 31, 2011				
Money market funds	$5,665	$ 5,665	$—	$—
Total	$5,665	$ 5,665	$—	$—

At September 30, 2012, accounts receivable and accounts payable are not measured at fair value; however, the Company believes that the carrying amounts of these assets and liabilities are a reasonable estimate of their fair value. Accounts receivable and accounts payable are categorized as Level 2.
There have been no changes in Level 1, Level 2 and Level 3 and no changes in valuation techniques for these assets or liabilities for the period ended September 30, 2012.

Note 4: Intangible Assets
Intangible assets consist of the following (in thousands):

	September 30, 2012	December 31, 2011
Internet domain names	$2,117	$2,117
Accumulated amortization	(1,677)	(1,413)
Total	$440	$704

Intangible assets have a useful life of 5 years. For the three months ended September 30, 2012 and 2011, amortization expense was $88,000 for each period. For the nine months ended September 30, 2012 and 2011, amortization expense was $264,000 for each period.
Future expected amortization expense related to intangible assets at September 30, 2012 is as follows (in thousands):

Remainder of 2012	90
2013	350
Total	$440

The expected amortization expense is an estimate. Actual amounts of amortization expense may differ from estimated amounts due to additional intangible asset acquisitions, impairment of intangible assets, accelerated amortization of intangible assets and other events.

Note 5: Commitments and Contingencies
Beginning on August 9, 2011, two purported class action lawsuits were commenced in the United States District Court for the Southern District of New York. On January 6, 2012, a Consolidated and Amended Class Action Complaint was filed.

Table of Contents

The complaint asserts claims under Section 10(b) and 20(a) pursuant to the Securities Exchange Act of 1934 (“Exchange Act”) alleging that between March 16, 2011 and July 21, 2011, the Company and/or the individual defendants purportedly issued materially false and misleading statements. In particular, the complaint asserts, among other things, allegations challenging certain statements relating to the Company’s growth. The complaint also makes allegations regarding the Company’s Getaways business and asserts that certain officers and directors sold stock while in possession of materially adverse non-public information. The action seeks unspecified damages and we are unable to estimate the possible loss or range of losses that could potentially result from the action. The Company believes that the action is without merit and intends to defend the suits vigorously.

In addition, five shareholder derivative lawsuits, Wang v. Bartel, et al., Wirth v. Bartel, et al., Kitt v. Bartel, et al., Blatt v. Bartel, et al., and Turansky v. Bartel, et al., were filed in the Southern District of New York based on similar allegations that seek to assert claims under state law derivatively on behalf of Travelzoo against certain officers and directors of the Company. These derivative actions were consolidated and on January 6, 2012, a Verified Consolidated Shareholder Derivative Complaint was filed purportedly on behalf of nominal defendant Travelzoo. The complaint asserts claims for breaches of fiduciary duties, unjust enrichment, abuse of control and gross mismanagement against current and former directors and officers of the Company. The complaint also asserts a breach of fiduciary duty claim for insider trading against certain officers and directors, as well as Azzurro Capital, Inc. The derivative action makes allegations regarding the Company’s Getaways business and asserts that certain officers and directors sold stock while in possession of materially adverse non-public information.

On January 27, 2012, a purported shareholder of Travelzoo commenced a suit in the Supreme Court of New York that allegedly asserts claims derivatively on behalf of Travelzoo Inc. for breaches of fiduciary duty against Travelzoo’s board of directors. The complaint also asserts claims for breaches of fiduciary duty and unjust enrichment against Ralph Bartel and Azzurro Capital Inc. The complaint challenges Travelzoo’s sale of its Asia Pacific division for $3.6 million to Azzurro and alleges that the transaction was not entirely fair to the Company.

On September 28, 2012, Metasearch Systems, LLC filed a lawsuit in the United States District Court for the Eastern District of Delaware against Travelzoo Inc. d/b/a Fly.com alleging infringement of several U.S. patents. Metasearch Systems alleges that the trip-planning metasearch service available on Fly.com infringes one or more claims of the asserted patents. During September 2012, Metasearch Systems filed similar lawsuits against several of Travelzoo's competitors including Expedia, Inc., Orbitz Worldwide, Inc., Travelocity .com, LP, Priceline.com, Inc., Yahoo! Inc., American Express Company, KAYAK Software Corp., and BookIt.com. The action seeks unspecified damages and we are unable to estimate the possible loss or range of losses that could potentially result from the action. Travelzoo is assessing its obligations and liability, if any, in respect of this litigation and intends to vigorously defend itself in the litigation.

On April 21, 2011, the Company entered into an agreement with the State of Delaware resolving all claims relating to an unclaimed property review which began in 2010. The primary issue raised in the preliminary findings from the review, received by the Company on April 12, 2011, concerned the shares of Travelzoo, which have not been claimed by former Netsurfer stockholders of Travelzoo.com (unexchanged promotional merger shares) as discussed further in Note 1. In the preliminary findings under the unclaimed property review, up to 3.0 million shares were identified as “demandable” under Delaware escheat laws. While the Company continues to take the position that such shares were a promotional incentive and were issuable only to persons who established their eligibility as stockholders, the Company determined that it was in its best interest to promptly resolve all claims relating to the unclaimed property review. The Company made a $20.0 million cash payment to the State of Delaware on April 27, 2011 and received a complete release of those claims.

As discussed in Note 1 above, during March 2012, the Company has become subject to unclaimed property reviews by most of the other states in the U.S. that relate primarily to the unexchanged promotional merger shares, which were not covered by the settlement and release by the State of Delaware. During the three months ended March 31, 2012, the Company recorded a $3 million charge related to this unexchanged promotional merger shares contingency. While the Company believes it has meritorious defenses regarding the applicability of escheat rights related to this unexchanged promotional merger shares contingency, the ultimate resolution of this matter may take longer than one year to resolve. If the claims for all of the additional shares referred to in the preliminary findings were upheld in full, based on the closing price of the Company’s shares at the end of September 2012, the cost to the Company would be approximately $23.2 million in excess of the amount accrued, plus any interest or penalties which might be applicable. In addition, the total amount of exposure of this contingency is dependent upon the manner in which each state applies its unclaimed property laws. The Company is not able to predict the ultimate amount or outcome of any current or future claims which have been or might be asserted relating to the unissued shares.

The Company is continuing its program under which it makes cash payments to people who establish that they satisfy the conditions to receive shares of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares

Table of Contents

of Travelzoo Inc. within the required time period. The accompanying condensed consolidated financial statements include a charge in general and administrative expenses of $2,000 and $24,000 for these cash payments for the three months and nine months ended September 30, 2012. The total cost of this program is not reliably estimable because it is based on the ultimate number of valid requests received and future levels of the Company's common stock price, and would be affected by any settlement of the pending unclaimed property reviews referred to above. The Company's common stock price affects the liability because the amount of cash payments under the program is based in part on the recent level of the stock price at the date valid requests are received.

The Company leases office space in Canada, France, Germany, Spain, the U.K., and the U.S. under operating leases which expire between April 30, 2012 and March 31, 2022. The future minimum lease payments under these operating leases as of September 30, 2012 total $15.7 million. The future lease payments consist of $1,263,000 due in 2012, $4,427,000 due in 2013, $2,432,000 due in 2014, $2,304,000 due in 2015, $1,945,000 due in 2016, and $3,342,000 thereafter.

Local Deals and Getaway merchant payable included in accounts payable was $19.3 million and $16.0 million, as of September 30, 2012 and December 31, 2011, respectively.

Note 6: Stock-Based Compensation

In November 2009, the Company granted employee options to purchase 300,000 shares of common stock with an exercise price of $14.97, of which 75,000 options vest and become exercisable annually starting July 1, 2011. The options expire in November 2019. As of September 30, 2012, 150,000 of these options were vested and 300,000 options were outstanding. Total stock-based compensation for the three months ended September 30, 2012 and 2011 related to this 300,000 option grant was $187,000 for each period. Total stock-based compensation for the nine months ended September 30, 2012 and 2011 related to this 300,000 stock option grant was $562,000 for each period. As of September 30, 2012, there was approximately $1.3 million of unrecognized stock-based compensation expense. This amount is expected to be recognized over 1.8 years. In January 2012, the Company granted employee options to purchase 100,000 shares of common stock with an exercise price of $28.98, of which 25,000 options become exercisable annually starting January 23, 2013. The options expire in January 2022. As of September 30, 2012, none of these options were vested and 100,000 options were outstanding. Total stock-based compensation for the three months ended September 30, 2012 related to this 100,000 option grant was $119,000. Total stock-based compensation for the nine months ended September 30, 2012 related to this 100,000 option grant was $338,000. As of September 30, 2012, there was approximately $1.6 million of unrecognized stock-based compensation expense. This amount is expected to be recognized over 3.3 years. The Company used a forfeiture rate of 0% as the Company does not have enough historical forfeiture data to estimate the forfeiture rate. To the extent the actual forfeiture rate is greater than what we have anticipated, stock-based compensation related to these options will be lower than our expectations.

Note 7: Income Taxes

In determining the quarterly provisions for income taxes, the Company uses an estimated annual effective tax rate which is generally based on our expected annual income and statutory tax rates in the U.S. and Canada. For the nine months ended September 30, 2012, the Company's effective tax rate was 32%, treating the $3.0 million accrued expense for unexchanged promotional merger shares as having no recognizable tax benefits. For the nine months ended September 30, 2011, the Company's effective tax rate was 145%, treating the $20.0 million expense for the settlement with the State of Delaware as having no recognizable tax benefits.

United States income and foreign withholding taxes have not been provided on undistributed earnings for certain non-U.S. subsidiaries. The undistributed earnings on a book basis for the non-U.S. subsidiaries are approximately $1.7 million. The Company intends to reinvest these earnings indefinitely in its operations outside the U.S. If the undistributed earnings are remitted to the U.S. these amounts would be taxable in the U.S at the current federal and state tax rates net of foreign tax credits. Also, depending on the jurisdiction any distribution may be subject to withholding taxes at rates applicable for that jurisdiction.

The Company maintains liabilities for uncertain tax positions. To the extent accrued interest and penalties do not ultimately become payable, amounts accrued will be reduced and reflected as a reduction in the overall income tax provision in the period that such determination is made. At September 30, 2012, the Company had approximately $9.3 million in total unrecognized tax benefits. Unrecognized tax benefits of approximately $7.9 million which, if recognized, would favorably affect the Company’s effective income tax rate, and unrecognized tax benefits of approximately $1.4 million which if recognized, would be recorded in discontinued operations. The increase in the unrecognized tax benefit for the three months

Table of Contents

ended September 30, 2012 is related to a deduction taken on the Company's 2011 U.S. federal and state income tax returns for the $20 million settlement with the State of Delaware.

The Company’s policy is to include interest and penalties related to unrecognized tax positions in income tax expense. As of September 30, 2012 and December 31, 2011, the Company had approximately $558,000 and $391,000, respectively, in accrued interest and penalties related to uncertain tax positions. The Company is in various stages of multiple year examinations by federal and state taxing authorities. Although the timing of resolution and/or closure on audits is highly uncertain, it is reasonably possible that the balance of the gross unrecognized tax benefits related to the method of computing income taxes in certain jurisdiction and losses reported on certain income tax returns could significantly change in the next 12 months. These changes may occur through settlement with the taxing authorities or the expiration of the statute of limitations on the returns filed. The Company is unable to estimate the range of possible adjustments to the balance of the gross unrecognized tax benefits.

The Company files income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. The Company is subject to U.S. federal and certain state tax examinations for years after 2008 and is subject to California tax examinations for years after 2004.

Note 8: Segments

The Company manages its business geographically and has two reportable operating segments: North America and Europe. North America consists of the Company’s operations in Canada and the U.S. Europe consists of the Company’s operations in France, Germany, Spain, and the U.K.

Management relies on an internal management reporting process that provides revenue and segment operating income (loss) for making financial decisions and allocating resources. Management believes that segment revenues and operating income (loss) are appropriate measures of evaluating the operational performance of the Company’s segments. The following is a summary of operating results from continuing operations and assets (in thousands) by business segment:

Three Months Ended September 30, 2012	North America	Europe	Elimination	Consolidated
Revenues from unaffiliated customers	$25,147	$10,300	$—	$35,447
Intersegment revenues	211	10	(221)	—
Total net revenues	25,358	10,310	(221)	35,447
Operating income	$3,121	$1,074	$—	$4,195

Three Months Ended September 30, 2011	North America	Europe	Elimination	Consolidated
Revenues from unaffiliated customers	$27,944	$10,717	$—	$38,661
Intersegment revenues	130	30	(160)	—
Total net revenues	28,074	10,747	(160)	38,661
Operating income	$7,811	$1,414	$—	$9,225

Nine Months Ended September 30, 2012	North America	Europe	Elimination and Other (a)	Consolidated
Revenues from unaffiliated customers	$82,415	$31,725	$—	$114,140
Intersegment revenues	496	41	(537)	—
Total net revenues	82,911	31,766	(537)	114,140
Operating income	$18,094	$6,038	$(3,000)	$21,132

Table of Contents

Nine Months Ended September 30, 2011