XL GROUP PLC
Form 10-Q
May 09, 2011

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

FORM 10-Q

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

For the quarterly period ended March 31, 2011

OR

o 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 1-10804

XL GROUP
Public Limited Company
(Exact name of registrant as specified in its charter)

Ireland	98-0665416
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

No. 1 Hatch Street Upper, 4th Floor, Dublin 2, Ireland
(Address of principal executive offices and zip code)
+353 (1) 405-2033
(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 x No o

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

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. (Check one):

Large accelerated filer x Accelerated filer o Non-accelerated filer o Smaller reporting company o

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

As of May 5, 2011, there were 309,415,211 outstanding Ordinary Shares, $0.01 par value per share, of the registrant.

XL GROUP PLC

INDEX TO FORM 10-Q

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

XL GROUP PLC

CONSOLIDATED BALANCE SHEETS

(U.S. dollars in thousands, except share data)	**(Unaudited) March 31, 2011**	**December 31, 2010**
ASSETS		
Investments:		
Fixed maturities at fair value (amortized cost: 2011, $25,013,905; 2010, $25,714,886)	$ 24,870,615	$ 25,544,179
Equity securities, at fair value (cost: 2011, $235,470; 2010, $56,737)	270,992	84,767
Short-term investments, at fair value (amortized cost: 2011, $2,379,789; 2010, $2,058,447)	2,376,783	2,048,607
Total investments available for sale	27,518,390	27,677,553
Fixed maturities, held to maturity at amortized cost (fair value: 2011, $2,773,590; 2010, $2,742,626)	$ 2,828,108	$ 2,728,335
Investments in affiliates	1,028,259	1,069,028
Other investments	977,695	951,723
Total investments	32,352,452	32,426,639
Cash and cash equivalents	3,385,805	3,022,868
Accrued investment income	327,308	350,091
Deferred acquisition costs	707,681	633,035
Ceded unearned premiums	721,163	625,654
Premiums receivable	2,943,211	2,414,912
Reinsurance balances receivable	178,154	171,327
Unpaid losses and loss expenses recoverable	3,588,935	3,671,887
Net receivable from investments sold		21,716
Goodwill and other intangible assets	842,054	839,508
Deferred tax asset	162,513	143,525
Other assets	672,865	702,189
Total assets	$ 45,882,141	$ 45,023,351
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Unpaid losses and loss expenses	$ 20,776,958	$ 20,531,607
Deposit liabilities	1,670,609	1,684,606
Future policy benefit reserves	5,224,984	5,075,127
Unearned premiums	4,074,090	3,484,830
Notes payable and debt	2,462,917	2,464,410
Reinsurance balances payable	351,181	122,250
Net payable for investments purchased	33,769	34,315
Deferred tax liability	82,287	105,667
Other liabilities	865,200	835,590
Total liabilities	$ 35,541,995	$ 34,338,402
Commitments and Contingencies		
Non-controlling interest - Redeemable Series C preference ordinary shares, 20,000,000 authorized, par value $0.01; Issued and outstanding: (2011, 2,846,000; 2010, 2,876,000)	$ 71,150	$ 71,900

Shareholders Equity:		
Ordinary shares, 999,990,000 authorized, par value $0.01; Issued and outstanding: (2011, 309,361,883; 2010, 316,396,289)	3,094	3,165
Additional paid in capital	8,836,764	8,993,016
Accumulated other comprehensive income	175,098	100,795
Retained earnings	252,242	513,777
Shareholders equity attributable to XL Group plc	$ 9,267,198	$ 9,610,753
Non-controlling interest in equity of consolidated subsidiaries	1,001,798	1,002,296
Total shareholders equity	$ 10,268,996	$ 10,613,049
Total liabilities, redeemable preference ordinary shares and shareholders equity	$ 45,882,141	$ 45,023,351

See accompanying Notes to Unaudited Consolidated Financial Statements

XL GROUP PLC

CONSOLIDATED STATEMENTS OF INCOME

	(Unaudited) Three Months Ended March 31,	
	2011	2010
(U.S. dollars in thousands, except per share data)		
Revenues:		
Net premiums earned	$ 1,361,383	$ 1,368,485
Net investment income	280,263	308,324
Realized investment gains (losses):		
Net realized gains (losses) on investments sold	(28,992)	4,021
Other-than-temporary impairments on investments	(33,720)	(60,514)
Other-than-temporary impairments on investments transferred to (from) other comprehensive income	(3,725)	20,317
Total net realized gains (losses) on investments	(66,437)	(36,176)
Net realized and unrealized gains (losses) on derivative instruments	3,567	(20,480)
Income (loss) from investment fund affiliates	27,150	8,178
Fee income and other	8,932	8,418
Total revenues	$ 1,614,858	$ 1,636,749
Expenses:		
Net losses and loss expenses incurred	$ 1,208,865	$ 892,200
Claims and policy benefits	133,231	123,743
Acquisition costs	188,490	201,137
Operating expenses	260,527	229,108
Exchange (gains) losses	9,514	(21,083)
Interest expense	54,147	49,070
Amortization of intangible assets	465	465
Total expenses	$ 1,855,239	$ 1,474,640
Income (loss) before income tax and income (loss) from operating affiliates	$ (240,381)	$ 162,109
Provision (benefit) for income tax	(32,797)	29,836
Income (loss) from operating affiliates	13,636	11,606
Net income (loss)	$ (193,948)	$ 143,879
Non-controlling interests	(33,336)	1
Net income (loss) attributable to XL Group plc	$ (227,284)	$ 143,880
Preference share dividends		(32,500)
Gain on redemption of Series C preference ordinary shares		16,616
Net income (loss) attributable to ordinary shareholders	$ (227,284)	$ 127,996
Weighted average ordinary shares and ordinary share equivalents outstanding basic	311,478	342,148
Weighted average ordinary shares and ordinary share equivalents outstanding diluted	311,478	342,760
Earnings per ordinary share and ordinary share equivalent basic	$ (0.73)	$ 0.37

Earnings per ordinary share and ordinary share equivalent diluted	$ (0.73)	$ 0.37

See accompanying Notes to Unaudited Consolidated Financial Statements

XL GROUP PLC

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(U.S. dollars in thousands)	(Unaudited) Three Months Ended March 31, 2011	2010
Net income (loss) attributable to XL Group plc	$ (227,284)	$ 143,880
Change in net unrealized gains (losses) on investments, net of tax	13,379	542,109
Change in net unrealized gains (losses) on affiliate and other investments, net of tax	24,235	13,915
Change in OTTI losses recognized in other comprehensive income, net of tax	25,307	(16,458)
Change in underfunded pension liability	(344)	3,482
Change in value of cash flow hedge	110	110
Change in net unrealized gain (loss) on future policy benefit reserves		(2,752)
Foreign currency translation adjustments, net	11,616	(32,485)
Comprehensive income (loss)	$ (152,981)	$ 651,801

See accompanying Notes to Unaudited Consolidated Financial Statements

XL GROUP PLC

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	(Unaudited) Three Months Ended March 31,	
	2011	2010
(U.S. dollars in thousands)		
Non-controlling Interest in Equity of Consolidated Subsidiaries:		
Balance beginning of year	$ 1,002,296	$ 2,305
Non-controlling interests	4	$ (1)
Non-controlling interest share in change in accumulated other comprehensive (income) loss	(2)	1
Purchase of Series E preference ordinary shares	(500)	
Balance end of period	$ 1,001,798	$ 2,305
Series E Preference Ordinary Shares:		
Balance beginning of year	$	$ 10
Balance end of period	$	$ 10
Ordinary Shares:		
Balance beginning of year	$ 3,165	$ 3,421
Issuance of ordinary shares	2	
Exercise of stock options		1
Buybacks of ordinary shares	(73)	(1)
Balance end of period	$ 3,094	$ 3,421
Additional Paid in Capital:		
Balance beginning of year	$ 8,993,016	$ 10,474,688
Issuance of ordinary shares	8	8
Buybacks of ordinary shares	(166,429)	(1,840)
Exercise of stock options, net of tax		104
Share based compensation expense	10,169	9,269
Balance end of period	$ 8,836,764	$ 10,482,229
Accumulated Other Comprehensive Income (Loss):		
Balance beginning of year	$ 100,795	$ (1,142,467)
Change in net unrealized gains (losses) on investments, net of tax	13,379	542,109
Change in net unrealized gains (losses) on affiliate and other investments, net of tax	24,235	13,915
Change in OTTI losses recognized in other comprehensive income, net of tax	25,307	(16,458)
Change in underfunded pension liability	(344)	3,482
Change in value of cash flow hedge	110	110
Foreign currency translation adjustments	11,616	(32,485)
Change in net unrealized gain (loss) on future policy benefit reserves		(2,752)
Balance end of period	$ 175,098	$ (634,546)
Retained Earnings (Deficit):		
Balance beginning of year	$ 513,777	$ 94,460
Net income attributable to XL Group plc	(227,284)	143,880
Dividends on Series E preference ordinary shares		(32,500)

Dividends on ordinary shares	(34,251)	(34,312)
Gain on redemption of Series C preference ordinary shares		16,616
Balance end of period	$ 252,242	$ 188,144
Total Shareholders Equity	$ 10,268,996	$ 10,041,563

See accompanying Notes to Unaudited Consolidated Financial Statements

XL GROUP PLC

CONSOLIDATED STATEMENTS OF CASH FLOWS

	(Unaudited Three Months I March 31,	
	2011	**2**
(U.S. dollars in thousands)		
Cash flows provided by (used in) operating activities:		
Net income (loss)	$ (193,948)	$ 1
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Net realized losses on sales investments	66,437	
Net realized and unrealized losses on derivative instruments	(3,567)	
Amortization of (discounts) on fixed maturities	19,861	
(Income) loss from investment and operating affiliates	(40,786)	
Amortization of deferred compensation	8,829	
Accretion of convertible debt	249	
Accretion of deposit liabilities	16,887	
Unpaid losses and loss expenses	29,810	
Depreciation expense	11,969	
Future policy benefit reserves	(24,989)	
Unearned premiums	524,331	3
Premiums receivable	(476,200)	(3
Unpaid losses and loss expenses recoverable	112,365	
Ceded unearned premiums	(84,247)	
Reinsurance balances receivable	(5,617)	
Deferred acquisition costs	(62,634)	
Reinsurance balances payable	220,048	
Deferred tax asset	(42,956)	
Derivatives	53,240	
Other assets	(3,841)	
Other liabilities	(103,843)	(1
Other	41,937	
Total adjustments	$ 257,283	$
Net cash provided by (used in) operating activities	$ 63,335	$ 2
Cash flows provided by (used in) investing activities:		
Proceeds from sale of fixed maturities and short-term investments	$ 1,122,182	$ 1,2
Proceeds from redemption of fixed maturities and short-term investments	689,130	6
Proceeds from sale of equity securities	70,349	
Purchases of fixed maturities and short-term investments	(1,188,395)	(2,3
Purchases of equity securities	(248,446)	
Net dispositions of investment affiliates	51,170	
Other investments, net	4,103	
Net cash provided by (used in) investing activities	$ 500,093	$ (2
Cash flows (used in) financing activities:		
Buybacks of ordinary shares	$ (166,502)	$
Redemption of Series C preference ordinary shares		
Dividends paid on ordinary shares	(34,021)	
Dividends paid on preference ordinary shares		
Distributions to non-controlling interests	(2,287)	
Deposit liabilities	(26,648)	

Net cash (used in) financing activities	$ (229,458)	$ (1
Effects of exchange rate changes on foreign currency cash	28,967	
Increase (decrease) in cash and cash equivalents	362,937	(2
Cash and cash equivalents beginning of period	3,022,868	3,6
Cash and cash equivalents end of period	$ 3,385,805	$ 3,3

See accompanying Notes to Unaudited Consolidated Financial Statements

XL GROUP PLC

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Preparation and Consolidation

These unaudited consolidated financial statements include the accounts of the Company and all of its subsidiaries and have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In addition, the year-end balance sheet data were derived from audited financial statements but does not include all disclosures required by GAAP. In the opinion of management, these unaudited financial statements reflect all adjustments (consisting of normal recurring accruals) considered necessary for a fair statement of financial position and results of operations at the end of and for the periods presented. The results of operations for any interim period are not necessarily indicative of the results for a full year. All significant inter-company accounts and transactions have been eliminated. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from these estimates.

To facilitate period-to-period comparisons, certain reclassifications have been made to prior period consolidated financial statement amounts to conform to current period presentation.

For periods prior to July 1, 2010, unless the context otherwise indicates, references herein to the Company are to, and these financial statements include the accounts of, XL Group Ltd. (formerly, XL Capital Ltd), a Cayman Islands exempted company (XL-Cayman), and its consolidated subsidiaries. For periods subsequent to July 1, 2010, unless the context otherwise indicates, references herein to the Company are to, and these financial statements include the accounts of, XL Group plc, an Irish public limited company (XL-Ireland), and its consolidated subsidiaries.

On July 1, 2010, XL-Ireland and XL-Cayman completed a redomestication transaction in which all of the ordinary shares of XL-Cayman were exchanged for all of the ordinary shares of XL-Ireland (the Redomestication). As a result, XL-Cayman became a wholly owned subsidiary of XL-Ireland.

As part of the Redomestication, neither the Redeemable Series C preference ordinary shares nor the Series E preference ordinary shares were transferred from XL-Cayman to XL-Ireland. Accordingly, subsequent to July 1, 2010, these instruments represent non-controlling interests in the consolidated financial statements of the Company. The Redeemable Series C preference ordinary shares should have been reclassified as Non-controlling interest – Redeemable Series C preference ordinary shares and the Series E preference ordinary shares should have been reclassified as Non-controlling interest in equity of consolidated subsidiaries. As a result, during the annual period ended December 31, 2010 and the quarterly period ended September 30, 2010, amounts related to the Redeemable Series C preference ordinary shares and the Series E preference ordinary shares were not correctly classified in the consolidated financial statements of the Company. Management believes that the misclassifications are not material to the previously issued financial statements and accordingly, the Company has revised the December 31, 2010 financial statements in this report, and will revise September 30, 2010 financial statements when included in the Company s quarterly report on Form 10-Q for the quarterly period ended September 30, 2011. The details of these classification errors are provided below for the annual period ended December 31, 2010. None of the revised classifications affected our total shareholders equity, net income or net income attributable to ordinary shareholders in any period. Details of the reclassifications are as follows:

Consolidated Balance Sheet at December 31, 2010 *(U.S. dollars in thousands)*:	**Previously Reported**	**Revised**
Series E preference ordinary shares, 1,000,000 authorized, par value $0.01; Issued and outstanding: (2010, 1,000,000; 2009, 1,000,000)	$ 10	$
Additional paid in capital	9,993,006	8,993,016
Shareholders equity attributable to XL Group plc	10,610,753	9,610,753
Non-controlling interest in equity of consolidated subsidiaries	2,296	1,002,296
Consolidated Statement of Income and Comprehensive Income for the year ended December 31, 2010 *(U.S. dollars in thousands)*:		
Non-controlling interests	$ (4)	$ (39,831)
Net income (loss) attributable to XL Group plc	643,377	603,550
Preference share dividends	(74,521)	(34,694)
Comprehensive income (loss)	1,886,639	1,846,812

8

XL GROUP PLC

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Significant Accounting Policies

(a) Recent Accounting Pronouncements

In June 2009, the FASB issued final authoritative guidance over accounting for transfers of financial assets that removed the concept of a qualifying special-purpose entity from existing accounting guidance over transfers of financial assets and also removes the exception from applying guidance surrounding consolidation of variable interest entities to qualifying special-purpose entities. This new guidance was applied by the Company from January 1, 2010; however, it did not have an impact on the Company s financial condition or results of operations.

In June 2009, the FASB issued final authoritative accounting guidance in an effort to improve financial reporting by enterprises involved with variable interest entities. This guidance retains the scope of the previous standard covering variable interest entities except, as noted above, with the addition of entities previously considered qualifying special-purpose entities. The new guidance requires an enterprise to perform an analysis to determine whether the enterprise s variable interest or interests give it a controlling financial interest in a variable interest entity under revised guidance that are more qualitative than under previous guidance and amends previous guidance to require ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. Before this update, previous guidance required reconsideration of whether an enterprise is the primary beneficiary of a variable interest entity only when specific events occurred. The new guidance also amends previous guidance to require enhanced disclosures that provide users of financial statements with more transparent information about an enterprise s involvement with a variable interest entity. The enhanced disclosures are required for any enterprise that holds a variable interest in a variable interest entity. The content of the enhanced disclosures required by this new guidance is generally consistent with that required by the previous standards. The Company applied this new guidance from January 1, 2010; however, it did not have an impact on the Company s financial condition and results of operations. See Note 10, Variable Interest Entities, for the disclosures required by this guidance.

In January 2010, the FASB issued an accounting standards update on Improving Disclosures about Fair Value Measurements. The provisions of this authoritative guidance require new disclosures about recurring and nonrecurring fair value measurements including significant transfers into and out of Level 1 and Level 2 fair value measurements and information on purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair value measurements. This guidance was effective for the Company from on January 1, 2010, except for the Level 3 reconciliation disclosures which are effective for annual periods beginning after December 15, 2010. See Note 3, Fair Value Measurements, for the Level 3 reconciliation disclosure changes made during the current quarter. This standard affects disclosures only and accordingly did not have an impact on the Company s financial condition or results of operations.

In July 2010, the FASB amended the general accounting principles for receivables as they relate to the disclosures about the credit quality of financing receivables and the allowance for credit losses. This amendment requires additional disclosures that provide a greater level of disaggregated information about the credit quality of financing receivables and the allowance for credit losses. It also requires the disclosure of credit quality indicators, past due information, and modifications of financing receivables. The new disclosures are required for interim and annual periods ending after December 15, 2010, although the disclosures of reporting period activity (i.e., allowance roll-forward and modification disclosures) are required for interim and annual periods beginning after December 15, 2010. This standard affects disclosures only and, accordingly, did not have an impact on the Company s financial condition or results of operations. During the fourth quarter of 2010, the Company recorded a provision of $9.9 million related to two structured loan investments. This provision remains unchanged at March 31, 2011. The Company holds investments in five separate structured loans with aggregate net carrying values of $42.0 million and $42.3 million at March 31, 2011 and December 31, 2010, respectively. In addition, the Company had gross reinsurance balances receivable and reinsurance recoverables on unpaid losses and loss expense of $3.9 billion at each of March 31, 2011 and December 31, 2010, against which an allowance of $120.2 million and $121.9 million was recorded at March 31, 2011 and December 31, 2010, respectively. There were no charge offs recorded during the current period.

XL GROUP PLC

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Significant Accounting Policies (Continued)

(a) Recent Accounting Pronouncements (Continued)

In October 2010, the FASB issued authoritative guidance to address disparities in practice regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. The amendments in the updated guidance specify that incremental direct costs of contract acquisition and certain costs related directly to the acquisition activities (i.e., underwriting, policy issuance and processing sales force contract selling, etc.) incurred in the acquisition of new or renewal contracts should be capitalized in accordance with the amendments in the updated guidance. Costs directly related to those activities include only the portion of an employee s total compensation (excluding any compensation that is capitalized as incremental direct costs of contract acquisition) and payroll-related fringe benefits related directly to time spent performing those activities for actual acquired contracts, and other costs related directly to those activities that would not have been incurred if the contract had not been acquired. Administrative costs, rent, depreciation, occupancy, equipment and all other general overhead costs are considered indirect costs and should be charged to expense as incurred. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. The amendments in this guidance should be applied prospectively upon adoption. Retrospective application is also permitted. This guidance is not expected to have an impact on the Company s financial condition or results of operations.

3. Fair Value Measurements

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price), in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants as of the measurement date. Applicable accounting guidance provides an established hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in valuing the asset or liability and are developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company s assumptions about the factors that market participants would use in valuing the asset or liability. Assets and liabilities are classified based on the lowest level of input that is significant to the fair value measurements. The Company reviews the fair value hierarchy classification on a quarterly basis. Changes in the observability of valuation inputs may result in a reclassification of levels for certain securities within the fair value hierarchy.

XL GROUP PLC

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

The following tables set forth the Company s assets and liabilities that were accounted for at fair value at March 31, 2011 and December 31, 2010 by level within the fair value hierarchy (for further information, see Item 8, Note 2, Significant Accounting Policies, to the Consolidated Financial Statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2010):

March 31, 2011 *(U.S. dollars in thousands) (Unaudited)*	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Collateral and Counterparty Netting**	**Balance at March 31, 2011**
Assets					
U.S. Government and Government-Related/Supported	$	$ 2,095,080	$	$	$ 2,095,080
Corporate (1)		9,993,235	34,866		10,028,101
Residential mortgage-backed securities Agency		5,025,609	32,987		5,058,596
Residential mortgage-backed securities Non-Agency		871,215	3,335		874,550
Commercial mortgage-backed securities		1,131,567	1,757		1,133,324
Collateralized debt obligations		13,558	742,284		755,842
Other asset-backed securities		939,937	12,371		952,308
U.S. States and political subdivisions of the States		1,357,215			1,357,215
Non-U.S. Sovereign Government, Supranational and Government-Related		2,615,599			2,615,599
Total fixed maturities, at fair value	$	$ 24,043,015	$ 827,600	$	$ 24,870,615
Equity securities, at fair value	245,248	25,744			270,992
Short-term investments, at fair value (1)(2)		2,376,497	286		2,376,783
Total investments available for sale	$ 245,248	$ 26,445,256	$ 827,886	$	$ 27,518,390
Cash equivalents (3)	1,795,331	425,325			2,220,656
Other investments (4)		506,507	144,834		651,341
Other assets (5)(6)		84,141	7,958	(22,741)	69,358
Total assets accounted for at fair value	$ 2,040,579	$ 27,461,229	$ 980,678	$ (22,741)	$ 30,459,745
Liabilities					
Financial instruments sold, but not yet purchased (7)	$	$ 23,324	$	$	$ 23,324
Other liabilities (5)(6)		102,307	44,768	(2,977)	144,098
Total liabilities accounted for at fair value	$	$ 125,631	$ 44,768	$ (2,977)	$ 167,422

XL GROUP PLC

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

December 31, 2010 *(U.S. dollars in thousands)*	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Collateral and Counterparty Netting**	**Balance at December 31, 2010**
Assets					
U.S. Government and Government-Related/Supported	$	$ 2,127,491	$	$	$ 2,127,491
Corporate (1)		10,325,725	35,158		10,360,883
Residential mortgage-backed securities Agency		5,134,491	30,255		5,164,746
Residential mortgage-backed securities Non-Agency		1,016,124	4,964		1,021,088
Commercial mortgage-backed securities		1,170,884	1,623		1,172,507
Collateralized debt obligations		12,566	721,097		733,663
Other asset-backed securities		924,181	24,650		948,831
U.S. States and political subdivisions of the States		1,351,677			1,351,677
Non-U.S. Sovereign Government, Supranational and Government-Related		2,659,626	3,667		2,663,293
Total fixed maturities, at fair value	$	$ 24,722,765	$ 821,414	$	$ 25,544,179
Equity securities, at fair value	71,284	13,483			84,767
Short-term investments, at fair value (1)(2)		2,046,424	2,183		2,048,607
Total investments available for sale	$ 71,284	$ 26,782,672	$ 823,597	$	$ 27,677,553
Cash equivalents (3)	1,358,619	540,646			1,899,265
Other investments (4)		490,320	133,717		624,037
Other assets (5)(6)		108,056	7,882	(20,152)	95,786
Total assets accounted for at fair value	$ 1,429,903	$ 27,921,694	$ 965,196	$ (20,152)	$ 30,296,641
Liabilities					
Financial instruments sold, but not yet purchased (7)	$ 256	$ 21,270	$	$	$ 21,526
Other liabilities (5)(6)		13,591	47,077	2,843	63,511
Total liabilities accounted for at fair value	$ 256	$ 34,861	$ 47,077	$ 2,843	$ 85,037

Notes:

(1) Included within Corporate are certain medium term notes supported primarily by pools of European credit with varying degrees of leverage. The notes had a fair value of $485.0 million and $454.8 million and an amortized cost of $511.7 million and $504.6 million at March 31, 2011 and December 31, 2010, respectively. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.

(2) Short-term investments consist primarily of Corporate, U.S. Government and Government-Related/Supported securities and Non-U.S. Sovereign Government, Supranational and Government-Related securities.

(3) Cash equivalents balances subject to fair value measurement include certificates of deposit and money market funds. Operating cash balances are not subject to fair value measurement guidance.

(4) The Other investments balance excludes certain structured transactions including certain investments in project finance transactions, a payment obligation and liquidity financing provided to a structured credit vehicle as a part of a third party medium term note facility. These investments are carried at amortized cost that totaled $326.4 million at March 31, 2011 and $327.7 million at December 31, 2010.

(5) Other assets and other liabilities include derivative instruments.

(6) The derivative balances included in each category above are reported on a gross basis by level with a netting adjustment presented separately in the Collateral and Counterparty Netting column. The Company often enters into different types of derivative contracts with a single counterparty and these contracts are covered under a netting agreement. In addition, the Company held net cash collateral related to derivative positions of approximately $19.8 million and $23.0 million at March 31, 2011 and December 31, 2010, respectively. This balance is included within cash and cash equivalents and the corresponding liability to return the collateral has been offset against the derivative positions within the balance sheet as appropriate under the netting agreement. The fair value of the individual derivative contracts are reported gross in their respective levels based on the fair value hierarchy.

(7) Financial instruments sold, but not yet purchased represent short sales and are included within Net payable for investments purchased on the balance sheet.

XL GROUP PLC

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

Level 3 Gains and Losses

The tables below present additional information about assets and liabilities measured at fair value on a recurring basis and for which Level 3 inputs were utilized to determine fair value. The table reflects gains and losses for the three month periods ended March 31, 2011 and 2010 for all financial assets and liabilities categorized as Level 3 at March 31, 2011 and 2010, respectively. The tables do not include gains or losses that were reported in Level 3 in prior periods for assets that were transferred out of Level 3 prior to March 31, 2011 and 2010. Gains and losses for assets and liabilities classified within Level 3 in the table below may include changes in fair value that are attributable to both observable inputs (Levels 1 and 2) and unobservable inputs (Level 3). Further, it should be noted that the following table does not take into consideration the effect of offsetting Level 1 and 2 financial instruments entered into by the Company that are either economically hedged by certain exposures to the Level 3 positions or that hedge the exposures in Level 3 positions.

In general, Level 3 assets include securities for which the values were obtained from brokers where either significant inputs were utilized in determining the value that were difficult to corroborate with observable market data, or sufficient information regarding the specific inputs utilized by the broker was not available to support a Level 2 classification. Transfers into or out of Level 3 primarily arise as a result of the valuations utilized by the Company changing between either those provided by independent pricing services that do not contain significant observable inputs, and other valuations sourced from brokers which are considered Level 3.

There were no transfers between Level 1 and Level 2 during the three month periods ended March 31, 2011 and 2010.

XL GROUP PLC

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

Level 3 Gains and Losses (continued)

(U.S. dollars in thousands) *(Unaudited)*	Level 3 Assets and Liabilities Three Months Ended March 31, 2011 Corporate	Residential mortgage-backed securities Agency	Residential mortgage-backed securities Non Agency	Commercial mortgage-backed securities	Collateralized debt obligations
Balance, beginning of period	$ 35,158	$ 30,255	$ 4,964	$ 1,623	$ 721,097
Realized gains (losses)				(889)	(652)
Movement in unrealized gains (losses)	55	38	6	1,040	26,088
Purchases and issuances	10,629	11,460			
Sales and settlements	(809)	(1,269)	(301)	(17)	(4,249)
Transfers into Level 3	4,397	3,944			
Transfers out of Level 3	(14,545)	(11,441)	(1,334)		
Fixed maturities to short-term investments classification change	(19)				
Balance, end of period	$ 34,866	$ 32,987	$ 3,335	$ 1,757	$ 742,284
Movement in total gains (losses) above relating to instruments still held at the reporting date	$ 51	$ 38	$ 6	$ 151	$ 25,436

(U.S. dollars in thousands) *(Unaudited)*	Level 3 Assets and Liabilities Three Months Ended March 31, 2011 (Continued) Other asset backed securities	Non-U.S. Sovereign Government and Supranationals and Government Related	Short-term Investments	Other investments	Derivative Contracts - Net
Balance, beginning of period	$ 24,650	$ 3,667	$ 2,183	$ 133,717	$ (39,195)
Realized gains (losses)	(452)				
Movement in unrealized gains (losses)	2,818		(51)	9,771	2,449
Purchases and issuances				1,864	
Sales and settlements	(9,650)		(1,327)	(518)	(64)
Transfers into Level 3					
Transfers out of Level 3	(4,995)	(3,667)	(538)		
Fixed maturities to short-term investments classification change			19		
Balance, end of period	$ 12,371	$	$ 286	$ 144,834	$ (36,810)
Movement in total gains (losses) above relating to instruments still held at the reporting date	$ 1,912	$	$ (43)	$ 8,707	$ 2,449

XL GROUP PLC

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

Level 3 Gains and Losses (continued)

(U.S. dollars in thousands) *(Unaudited)*	Level 3 Assets and Liabilities Three Months Ended March 31, 2010 Corporate	Residential mortgage-backed securities Agency	Residential mortgage-backed securities Non Agency	Commercial mortgage-backed securities	Collateralized debt obligations
Balance, beginning of period	$ 10,311	$ 7,894	$ 42,190	$ 2,755	$ 190,663
Realized gains (losses)	(4,319)		(817)	(457)	(4,917)
Movement in unrealized gains (losses)	26		4,392	1,337	31,384
Purchases and issuances					
Sales and settlements	(927)		(802)	(524)	(1,884)
Transfers into Level 3	8,158		117	38,544	496,503
Transfers out of Level 3	(2,600)	(7,894)	(15,080)		
Fixed maturities to short-term investments classification change	(1,156)				
Balance, end of period	$ 9,493	$	$ 30,000	$ 41,655	$ 711,749
Movement in total gains (losses) above relating to instruments still held at the reporting date	$ 165	$	$ 4,258	$ 888	$ 30,956

(U.S. dollars in thousands) *(Unaudited)*	Level 3 Assets and Liabilities Three Months Ended March 31, 2010 (Continued) Other asset backed securities	Non-U.S. Sovereign Government and Supranationals and Government Related	Short-term Investments	Other investments	Derivative Contracts - Net
Balance, beginning of period	$ 38,179	$ 3,217	$ 6,486	$ 75,584	$ 100,515
Realized gains (losses)	(6,351)		(2,848)		
Movement in unrealized gains (losses)	4,545	11	2,448	3,985	(1,390)
Purchases and issuances	23,976			4,746	5,462
Sales and settlements	(1,719)		(2,246)	(1,227)	(113)
Transfers into Level 3	204	14	1,570		
Transfers out of Level 3	(6,752)				
Fixed maturities to short-term investments classification change			1,156		
Balance, end of period	$ 52,082	$ 3,242	$ 6,566	$ 83,088	$ 104,474
Movement in total gains (losses) above relating to instruments still held at the reporting date	$ (1,820)	$ 11	$ 2,373	$ 3,985	$ (1,390)

15

XL GROUP PLC

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

Fixed maturities and short-term investments

At March 31, 2010, certain Collateralized Debt Obligations (CDOs) that were previously classified as Level 2 due to sufficient market data being available to allow a price to be determined and provided by third party pricing vendors, were transferred to Level 3 because third party vendor prices were no longer believed to be the most appropriate pricing source. Broker quotes, for which sufficient information regarding the specific inputs utilized by the broker was not available to support a Level 2 classification, are the primary source of the valuations for these CDO securities.

Other investments

Included within the Other investments component of the Company s Level 3 valuations are private investments and alternative investments where the Company is not deemed to have significant influence over the investee. The fair value of these investments is based upon net asset values received from the investment manager or general partner of the respective entity. The nature of the underlying investments held by the investee which form the basis of the net asset value include assets such as private business ventures and are such that significant Level 3 inputs are utilized in the determination of the individual underlying holding values and, accordingly, the fair value of the Company s investment in each entity is classified within Level 3. The Company also incorporates factors such as the most recent financial information received, the values at which capital transactions with the investee take place, and management s judgment regarding whether any adjustments should be made to the net asset value in recording the fair value of each position. Investments in alternative funds included in Other investments utilize strategies including Arbitrage, Directional, Event Driven and Multi-style. These funds potentially have lockup and gate provisions which may limit redemption liquidity. For further detaiVALIGN="bottom">$25 6/28/2010 6/28/2011

Total

$250

All of the above interest rate swap agreements are designated as cash flow hedges of interest rate risk. The effective portion of changes in the fair value of derivatives designated as, and that qualify as, cash flow hedges is recorded in Other Comprehensive Income (OCI) and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings.

The effective portion of Piedmont s derivative financial instruments (interest rate swaps) that was recorded in the accompanying consolidated statement of operations for the three months and nine months ended September 30, 2010 and 2009 (in thousands) is as follows:

Derivative in Cash Flow Hedging Relationships (Interest Rate Swap)	**Three Months Ended**		**Nine Months Ended**	
	September 30, 2010	**September 30, 2009**	**September 30, 2010**	**September 30, 2009**
Amount of loss recognized in OCI on derivative	$ 637	$ 843	$ 1,483	$ 2,563
Amount of previously recorded loss reclassified from accumulated OCI into interest expense	$ (350)	$ (2,033)	$ (4,321)	$ (5,844)

No gain or loss was recognized related to hedge ineffectiveness or to amounts excluded from effectiveness testing on Piedmont s cash flow hedges during the nine months ended September 30, 2010 or 2009.

Amounts reported in accumulated other comprehensive loss related to Piedmont s derivatives are reclassified to interest expense as interest payments are made on the $250 Million Unsecured Term Loan. Piedmont estimates that an additional $1.0 million will be reclassified from accumulated other comprehensive loss as an increase to interest expense over the next twelve months.

Table of Contents

The fair value of Piedmont s derivative financial instruments designated as hedging instruments under GAAP (its interest rate swap agreements) as of September 30, 2010 and December 31, 2009 was $1.0 million and $3.9 million, respectively, and was classified as an Other Liability in the accompanying consolidated balance sheet.

Please see the accompanying statements of stockholders equity for a rollforward of Piedmont s Other Comprehensive Loss account.

Credit-risk-related Contingent Features

Piedmont has agreements with its derivative counterparties that contain a provision whereby if Piedmont defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, then Piedmont could also be declared in default on its derivative obligation. If Piedmont breached any of the contractual provisions of the derivative contracts, it would be required to settle its obligations under the agreements at their termination value of the fair values plus accrued interest, or approximately $1.0 million.

8. Fair Value Measurements

Piedmont considers its cash, accounts receivable, notes receivable, accounts payable, interest rate swap agreements, and line of credit and notes payable to meet the definition of financial instruments. The following table sets forth the carrying and estimated fair value for each of Piedmont s financial instruments as of September 30, 2010 and December 31, 2009 (in thousands):

	As of September 30, 2010		As of December 31, 2009	
Financial Instrument	**Carrying Value**	**Estimated Fair Value**	**Carrying Value**	**Estimated Fair Value**
Cash and cash equivalents [1]	$ 67,539	$ 67,539	$ 10,004	$ 10,004
Tenant receivables, net[1]	$ 130,020	$ 130,020	$ 128,442	$ 128,442
Notes receivable	$ 60,671	$ [2]	$ 58,739	$ 44,504
Accounts payable[1]	$ 16,039	$ 16,039	$ 12,170	$ 12,170
Interest rate swap agreements	$ 1,028	$ 1,028	$ 3,866	$ 3,866
Line of credit and notes payable	$ 1,402,525	$ 1,422,946	$ 1,516,525	$ 1,436,060

(1) For the periods presented, the carrying value approximates estimated fair value.

(2) Due to the UCC foreclosure process and the litigation surrounding it, as well as the fact that the more junior note is technically in default, Piedmont is unable to provide an estimated fair value of the notes receivable as of September 30, 2010. See Note 5 for further information concerning Piedmont s notes receivable as of September 30, 2010.

Piedmont s interest rate swap agreements discussed in Note 7 above were the only financial instruments adjusted and carried at fair value as of September 30, 2010 and December 31, 2009 and were classified as an Interest rate swap in the accompanying consolidated balance sheets. The valuation of these instruments was determined using widely accepted valuation techniques including discounted cash flow analysis based on the contractual terms of the derivatives, including the period to maturity of each instrument, and uses observable market-based inputs, including interest rate curves and implied volatilities. Therefore, the fair values determined are considered to be based on significant other observable inputs (Level 2). In addition, Piedmont considered both its own and the respective counterparties risk of nonperformance in determining the fair value of its derivative financial instruments by estimating the current and potential future exposure under the derivative financial instruments that both Piedmont and the counterparties were at risk for as of the valuation date. This total expected exposure was then discounted using discount factors that contemplate the creditworthiness of Piedmont and the counterparties to arrive at a credit charge. This credit charge was then netted against the value of the derivative financial instruments determined using the discounted cash flow analysis described above to arrive at a total estimated fair value of the interest rate swap agreements. As of September 30, 2010 and December 31, 2009, the credit valuation adjustment did not comprise a material portion of the fair values of the derivative financial instruments; therefore, Piedmont believes that any unobservable inputs used to determine the fair values of its derivative financial instruments are not significant to the fair value measurements in their entirety, and does not consider its derivative financial instruments to be Level 3 liabilities.

See Note 9 below for further information on a certain long-lived asset which was adjusted to fair value during the three months ended September 30, 2010, and its classification within the fair value hierarchy in accordance with GAAP.

14

Table of Contents

9. Impairment of Certain Assets

During the three months ended September 30, 2010 and 2009, Piedmont recorded the following impairment charges (in thousands).

	September 30, 2010		September 30, 2009	
Impairment loss recorded in real estate operating expenses:				
Auburn Hills Corporate Center Building	$		$	10,173
1441 West Long Lake Road Building				10,616
1111 Durham Avenue Building				14,274
Impairment loss on real estate assets	$		$	35,063
Impairment loss recorded in equity in income/(loss) of unconsolidated joint ventures				
Wells/Fremont Associates Joint Venture (at Piedmont s approximate 78% ownership)	$		$	2,570
Fund IX, X, XI and REIT Joint Venture (at Piedmont s approximate 4% ownership)		53		
Impairment loss recorded in equity in income/(loss) of unconsolidated joint ventures	$	53	$	2,570

During the three months ended September 30, 2010, Piedmont analyzed its equity method investment in Fund IX, X, XI and REIT Joint Venture, which owns and operates the 360 Interlocken Building. The building was purchased in March 1998 and consists of a three-story office building located in Broomfield, Colorado totaling approximately 52,000 square feet. Due to refining the disposition strategy for this joint venture and, consequently, shortening the estimated holding period of this asset, Piedmont determined that the difference in fair value and carrying value for its pro-rata share of its investment in Fund IX, X, XI and REIT Joint Venture was other than temporary, and recorded an impairment charge of approximately $53,000 during the three months ended September 30, 2010. Piedmont owns approximately 4% of the building.

Piedmont did not recognize an impairment loss on its held-for-use, wholly-owned buildings during the current year; however, during the three months ended September 30, 2009, Piedmont reduced its intended holding periods for the Auburn Hills Corporate Center Building , purchased in May 2003 and comprising approximately 119,000 square feet, and the 1441 West Long Lake Road Building, purchased in June 2000 and comprising approximately 107,000 square feet, both of which are located in the Detroit, Michigan market. During the same period, Piedmont reduced the intended holding period for the 1111 Durham Avenue Building, purchased in November 2000 and comprising approximately 237,000 square feet, located in New Jersey. The decision to reduce future rental revenues and the holding periods for the two Detroit assets was prompted by the loss of prospective replacement tenants and overall market declines in the Detroit, Michigan market. Further, changes in management s expectation of re-leasing prospects of the New Jersey asset, coupled with general market declines in the South Plainfield submarket in which it is located, prompted the reduction of intended hold period and future rental revenues during the quarter ended September 30, 2009. The cumulative effect of these decisions triggered a reassessment of speculative leasing assumptions for these buildings, which entailed, among other things, evaluating market rents, leasing costs and the downtime necessary to complete necessary re-leasing activities. Based on a comparison of the projected undiscounted future cash flows with the net book value of the real estate and intangible assets, Piedmont determined that the carrying values of the assets were not recoverable and, accordingly, recorded an impairment loss on real estate assets in the amount of approximately $35.1 million to reduce the carrying value of the assets to their estimated fair value based upon the present value of future cash flows.

During the three months ended September 30, 2009, Piedmont also analyzed its equity method investment in Wells/Fremont Associates Joint Venture, which owns and operates the 47320 Kato Road Building. The building was purchased in July 1998 and consists of one, two-story office building located in Fremont, CA totaling approximately 58,000 square feet. Due to feedback received during renewal negotiations with the incumbent tenant as well as observed significant downward pressure on rental rates in the East Bay Research & Development submarket, which includes Fremont, California, Piedmont determined that the difference in fair value and carrying value for its pro-rata share of its investment in Wells/Fremont Associates Joint Venture was other than temporary , and recorded an impairment charge of approximately $2.6 million during the three months ended September 30, 2009. Piedmont owns approximately 78% of the building.

Table of Contents

Fair Value Consideration for Property Owned Through Investment in Unconsolidated Joint Venture

As of September 30, 2010, in accordance with GAAP regarding fair value measurements, Piedmont valued its investment in an unconsolidated joint venture using the fair value processes and techniques prescribed by authoritative literature. The fair value measurements used in these evaluations of non-financial assets are considered to be Level 3 valuations within the fair value hierarchy as defined in GAAP, as there are significant unobservable inputs. Examples of inputs Piedmont utilizes in its fair value calculations are discount rates, market capitalization rates, speculative leasing rates and assumptions, timing of leases, rental concessions and leasing capital, and sales prices. The following amounts represent the detail of the adjustments recognized using Level 3 inputs as of September 30, 2010 (in thousands):

Investment in Unconsolidated Joint Venture	Net Book Value	Impairment Recognized	Fair Value
Fund IX, X, XI and REIT Joint Venture (at Piedmont s approximate 4% ownership)	$ 240	$ 53	$ 187

10. Commitments and Contingencies

Commitments Under Existing Lease Agreements

Certain lease agreements include provisions that, at the option of the tenant, may obligate Piedmont to provide funding for capital improvements. Under its existing lease agreements, Piedmont may be required to fund significant tenant improvements, leasing commissions, and building improvements. In addition, certain lease agreements contain provisions that require Piedmont to issue corporate guarantees to provide funding for such capital improvements. Piedmont anticipates funding approximately $114.9 million in potential obligations for tenant improvements related to its existing lease portfolio over the respective lease terms, much of which Piedmont estimates may be required to be funded over the next five years. For most of Piedmont s leases, the timing of the actual funding of these tenant improvements is largely dependent upon tenant requests for reimbursement. In some cases, these obligations may expire with the leases without further recourse to Piedmont.

Contingencies Related to Tenant Audits

Certain lease agreements include provisions that grant tenants the right to engage independent auditors to audit their annual operating expense reconciliations. Such audits may result in the re-interpretation of language in the lease agreements which could result in the refund of previously recognized tenant reimbursement revenues, resulting in financial loss to Piedmont. Piedmont recorded approximately $45,000 and $0.5 million of additional reserves as a component of tenant reimbursement income during the three months ended September 30, 2010 and 2009, respectively, and a recovery of approximately $0.1 million and reserves of $1.0 million during the nine months ended September 30, 2010 and 2009, respectively, related to such tenant audits.

Assertion of Legal Action

In Re Wells Real Estate Investment Trust, Inc. Securities Litigation, Civil Action No. 1:07-cv-00862-CAP **(Upon motions to dismiss filed by defendants, parts of all seven counts were dismissed by the court. Counts III through VII were dismissed in their entirety. On August 2, 2010, the court ruled on various pre-trial motions and denied the defendants motion for summary judgment. The parties are preparing for trial, but no trial date has been set.)**

On March 12, 2007, a stockholder filed a purported class action and derivative complaint in the United States District Court for the District of Maryland against, among others, Piedmont, Piedmont s previous advisors, and the officers and directors of Piedmont prior to the closing of the Internalization. The complaint attempts to assert class action claims on behalf of those persons who received and were entitled to vote on the proxy statement filed with the SEC on February 26, 2007.

The complaint alleges, among other things, (i) that the consideration to be paid as part of the Internalization is excessive; (ii) violations of Section 14(a), including Rule 14a-9 thereunder, and Section 20(a) of the Exchange Act, based upon allegations that the proxy statement contains false and misleading statements or omits to state material facts; (iii) that the board of directors and the current and previous advisors breached their fiduciary duties to the class and to Piedmont; and (iv) that the proposed Internalization will unjustly enrich certain directors and officers of

Piedmont.

The complaint seeks, among other things, (i) certification of the class action; (ii) a judgment declaring the proxy statement false and misleading; (iii) unspecified monetary damages; (iv) to nullify any stockholder approvals obtained during the proxy process; (v) to nullify the Internalization; (vi) restitution for disgorgement of profits, benefits, and other compensation for wrongful conduct and fiduciary breaches; (vii) the nomination and election of new independent directors, and the retention of a new financial advisor to assess the advisability of Piedmont s strategic alternatives; and (viii) the payment of reasonable attorneys fees and experts fees.

On June 27, 2007, the plaintiff filed an amended complaint, which contains the same counts as the original complaint, described above, with amended factual allegations based primarily on events occurring subsequent to the original complaint and the addition of a Piedmont officer as an individual defendant.

On March 31, 2008, the court granted in part the defendants motion to dismiss the amended complaint. The court dismissed five of the seven counts of the amended complaint in their entirety. The court dismissed the remaining two counts with the exception of allegations regarding the failure to disclose in Piedmont s proxy statement details of certain expressions of interest by a third party in acquiring Piedmont. On April 21, 2008, the plaintiff filed a second amended complaint, which alleges violations of the federal proxy rules based upon allegations that the proxy statement to obtain approval for Internalization omitted details of certain expressions of interest in acquiring Piedmont. The second amended complaint seeks, among other things, unspecified monetary damages, to nullify and rescind Internalization, and to cancel and rescind any stock issued to the defendants as consideration for Internalization. On May 12, 2008, the defendants answered the second amended complaint.

On June 23, 2008, the plaintiff filed a motion for class certification. On September 16, 2009, the court granted the plaintiff s motion for class certification. On September 30, 2009, the defendants filed a petition for permission to appeal immediately the court s order granting the motion for class certification with the Eleventh Circuit Court of Appeals, which the Eleventh Circuit Court of Appeals denied on October 30, 2009.

On April 13, 2009, the plaintiff moved for leave to amend the second amended complaint to add additional defendants. The court denied the motion for leave to amend on June 23, 2009.

On December 4, 2009, the parties filed motions for summary judgment. On August 2, 2010, the court entered an order denying the defendants motion for summary judgment and granting, in part, the plaintiff s motion for partial summary judgment. On August 12, 2010, the defendants filed a motion seeking to certify the court s decision on the parties motions for summary judgment for immediate appeal. On November 1, 2010, the court denied the defendants motion to certify its order on the parties motions for summary judgment for immediate appeal. No trial date has been set.

Piedmont believes that the allegations contained in the complaint are without merit and will continue to vigorously defend this action. Due to the uncertainties inherent in the litigation process, it is not possible to predict the ultimate outcome of this matter at this time; however, as with any litigation, the risk of financial loss does exist.

***In Re Piedmont Office Realty Trust, Inc. Securities Litigation, Civil Action No. 1:07-cv-02660*-CAP (Upon motions to dismiss filed by defendants, parts of all four counts were dismissed by the court. Counts III and IV were dismissed in their entirety. The parties are engaged in discovery.)**

On October 25, 2007, the same stockholder mentioned above filed a second purported class action in the United States District Court for the Northern District of Georgia against Piedmont and its board of directors. The complaint attempts to assert class action claims on behalf of (i) those persons who were entitled to tender their shares pursuant to the tender offer filed with the SEC by Lex-Win Acquisition LLC, a former stockholder, on May 25, 2007, and (ii) all persons who are entitled to vote on the proxy statement filed with the SEC on October 16, 2007.

The complaint alleges, among other things, violations of the federal securities laws, including Sections 14(a) and 14(e) of the Exchange Act and Rules 14a-9 and 14e-2(b) promulgated thereunder. In addition, the complaint alleges that defendants have also breached their fiduciary duties owed to the proposed classes.

On December 26, 2007, the plaintiff filed a motion seeking that the court designate it as lead plaintiff and its counsel as class lead counsel, which the court granted on May 2, 2008.

On May 19, 2008, the lead plaintiff filed an amended complaint which contained the same counts as the original complaint. On June 30, 2008, defendants filed a motion to dismiss the amended complaint.

Table of Contents

On March 30, 2009, the court granted in part the defendants motion to dismiss the amended complaint. The court dismissed two of the four counts of the amended complaint in their entirety. The court dismissed the remaining two counts with the exception of allegations regarding (i) the failure to disclose information regarding the likelihood of a listing in our amended response to the Lex-Win tender offer and (ii) purported misstatements or omissions in our proxy statement concerning then-existing market conditions, the alternatives to a listing or extension that were explored by the defendants, the results of conversations with potential buyers as to our valuation, and certain details of our share redemption program. On April 13, 2009, defendants moved for reconsideration of the court s March 30, 2009 order or, alternatively, for certification of the order for immediate appellate review. The defendants also requested that the proceedings be stayed pending consideration of the motion. On June 19, 2009, the court denied the motion for reconsideration and the motion for certification of the order for immediate appellate review.

On April 20, 2009, the plaintiff, joined by a second plaintiff, filed a second amended complaint, which alleges violations of the federal securities laws, including Sections 14(a) and 14(e) of the Exchange Act and Rules 14a-9 and 14e-2(b) promulgated thereunder. The second amended complaint seeks, among other things, unspecified monetary damages, to nullify and void any authorizations secured by the proxy statement, and to compel a tender offer. On May 11, 2009, the defendants answered the second amended complaint.

On June 10, 2009, the plaintiffs filed a motion for class certification. The court granted the plaintiffs motion for class certification on March 10, 2010. On August 6, 2010, the Eleventh Circuit Court of Appeals granted the defendants petition for permission to appeal immediately the court s order granting the motion for class certification. The defendants filed their opening brief in support of their appeal of the class certification decision on September 15, 2010. The plaintiffs filed a response to the defendants brief on October 18, 2010. The parties are presently engaged in discovery.

Piedmont believes that the allegations contained in the complaint are without merit and will continue to vigorously defend this action. Due to the uncertainties inherent in the litigation process, it is not possible to predict the ultimate outcome of this matter at this time; however, as with any litigation, the risk of financial loss does exist.

11. Disposition of Real Estate Assets- Discontinued Operations

On May 5, 2010, Piedmont entered into a binding purchase and sale agreement to dispose of the 111 Sylvan Avenue Building located in Englewood Cliffs, NJ for a gross sale price of approximately $55.0 million, exclusive of closing costs, with an anticipated closing date of December 1, 2010. In accordance with GAAP, Piedmont reclassified the 111 Sylvan Avenue Building from real estate assets held-for-use (at cost) to real estate assets held-for-sale (at estimated fair value) on its consolidated balance sheet as of May 5, 2010. Piedmont recorded an impairment loss of approximately $9.6 million as a result of adjusting the assets to fair value (less estimated costs to sell) on May 5, 2010. The amount of gain or loss ultimately recognized on the sales transaction is subject to change as estimated transaction costs are realized in subsequent periods. The fair value measurement used in the evaluation of this non-financial asset is considered to be a Level 1 valuation within the fair value hierarchy as defined by GAAP, as there are direct observations and transactions involving the asset (i.e. the asset is being sold to a third-party purchaser).

The details, comprised of assets held for sale, are provided below (in thousands):

	September 30, 2010	**December 31, 2009**
Real estate assets held for sale, net:		
Land	**$ 10,803**	$ 10,803
Building and improvements, less accumulated depreciation of $11,748 and $11,229, as of September 30, 2010 and December 31, 2009, respectively	**44,197**	51,756
Total real estate assets held for sale, net	**$ 55,000**	$ 62,559
Other assets held for sale:		
Tenant receivables	**$ 65**	$ 355

Deferred lease costs, less accumulated amortization of $0 as of December 31, 2009				20
Total other assets held for sale	**$**	**65**	$	375
Other liabilities held for sale:				
Accrued transaction costs	**$**	**2,539**	$	
Total other liabilities held for sale	**$**	**2,539**	$	

Table of Contents

The details comprising income from discontinued operations are presented below (in thousands):

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Revenues:				
Rental income	**$ 1,595**	$ 1,594	**$ 4,783**	$ 4,783
Tenant reimbursements		2	**(2)**	2
	1,595	1,596	**4,781**	4,785
Expenses:				
Property operating costs	**5**	26	**22**	81
Depreciation		389	**519**	1,167
General and administrative expenses	**156**	45	**168**	71
	161	460	**709**	1,319
Operating income, excluding impairment loss	**1,434**	1,136	**4,072**	3,466
Impairment loss			**(9,587)**	
Income/(loss) from discontinued operations	**$ 1,434**	$ 1,136	**$ (5,515)**	$ 3,466

12. Stockholders Equity

Deferred Stock Awards

As of September 30, 2010, outstanding employee deferred stock awards were as follows:

	Outstanding Deferred Stock Awards				
Date of grant	**May 24, 2010**(1)	**May 24, 2010**(2)	**May 6, 2009**(2)	**April 21, 2008**(2)	**May 18, 2007**(2)
Shares granted	53,447	222,082	186,634	150,594	254,950
Shares withheld to pay taxes (3)		20,383	33,800	31,516	71,788
Shares unvested as of September 30, 2010	53,447	166,462	92,025	36,183	
Fair value per share of awards on date of grant(4)	$ 18.71	$ 18.71	$ 22.20	$ 26.10	$ 30.00

(1) Of the shares granted, one-third of the total shares vest on each of the first, second, and third anniversary of the grant date.

(2) Of the shares granted, 25% vested on the day of grant and the remaining shares, adjusted for any forfeitures, vest ratably on the anniversary date over the following three years.

(3) These shares were surrendered upon vesting to satisfy required minimum tax withholding obligations.

(4) The fair value of the awards is based on an assumed price on the date of grant. This grant date fair value is further reduced by the present value of dividends foregone on the unvested portion of the shares discounted at the appropriate risk-free rate.

During the three months ended September 30, 2010 and 2009, Piedmont recognized approximately $0.8 million and $0.7 million of compensation expense, respectively, related to restricted stock awards in the table above, all of which relates to the amortization of nonvested shares. During the nine months ended September 30, 2010 and 2009, Piedmont recognized in both periods approximately $3.1 million of compensation expense for the same restricted stock awards of which $2.1 million related to the amortization of nonvested shares. During the nine months ended September 30, 2010, 126,456 shares were issued to employees under all of the grants listed in the table above. As of

September 30, 2010, approximately $3.2 million of unrecognized compensation cost related to nonvested, share-based compensation remained, which Piedmont will record in its consolidated statements of income over a weighted-average vesting period of approximately one year.

2010 Long-Term Incentive Compensation Plan

On May 11, 2010, the compensation committee of the board of directors of Piedmont approved a 2010 Long-Term Incentive Compensation Plan (the 2010 LTIC Plan) for certain of its employees. The 2010 LTIC Plan specifies that each participant s annual opportunity to earn deferred stock awards will be divided equally between a deferred stock award (materially consistent with Piedmont s past practice) and a new Multi-Year Performance Share Compensation Program (the Performance Share Program).

The Performance Share Program provides an opportunity to earn long-term equity incentive compensation based on Piedmont s performance over a three-year period. Piedmont s performance will be measured by comparing Piedmont s total stockholder return relative to the total stockholder return for a group of peer companies as determined by Piedmont s compensation committee.

Table of Contents

In accordance with GAAP, expense is required to be recognized on a quarterly basis from the date of the plan grant. Expense recognized during the three months ended September 30, 2010 and nine months ended September 30, 2010 was approximately $0.3 million and $0.4 million, respectively.

Dividend Reinvestment Plan

Piedmont s dividend reinvestment plan (the DRP) was reinstated beginning with dividends declared and paid in the third quarter of 2010. Common stockholders may elect (if their brokerage agreements allow) to reinvest an amount equal to the dividends declared on their common shares into additional shares of Piedmont s Class A common stock in lieu of receiving cash dividends. Such shares of Class A common stock of Piedmont offered under the DRP will, at the election of Piedmont, either be purchased in the open market or purchased directly from Piedmont from authorized but unissued shares. If the shares are purchased directly from Piedmont, the purchase price for shares will be equal to 98% of the average of the high and low sales price of the Class A common stock reported on the New York Stock Exchange Composite Tape on the dividend payment date, except that if no trading is reported for such trading day, the purchase price shall be determined by Piedmont on the basis of such market quotations as it deems appropriate. If the shares are purchased in the open market, the purchase price for shares will be equal to 98% of the weighted average price of shares purchased to satisfy DRP requirements. On September 22, 2010, Piedmont s transfer agent purchased approximately 33,000 shares at a weighted-average price of $18.56 per share. Such shares were issued to stockholders participating in the DRP at $18.19 per share.

13. Earnings Per Share

There are no adjustments to Net income attributable to Piedmont or Income from continuing operations for the diluted earnings per share computations.

Net income per share-basic is calculated as net income available to common stockholders divided by the weighted average number of common shares outstanding during the period. Net income per share-diluted is calculated as net income available to common stockholders divided by the diluted weighted average number of common shares outstanding during the period, including nonvested restricted stock. Diluted weighted average number of common shares is calculated to reflect the potential dilution under the treasury stock method that would occur as if the remaining unvested restricted stock awards has vested and resulted in additional common shares outstanding.

The following table reconciles the denominator for the basic and diluted earnings per share computations shown on the consolidated statements of operations:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	**2009**	**2010**	**2009**
Weighted-average common shares basic	**172,658,489**	157,602,725	**170,110,216**	158,491,205
Plus incremental weighted-average shares from time-vested conversions:				
Restricted stock awards	**226,949**		**146,860**	132,518
Weighted-average common shares diluted	**172,885,438**	157,602,725[1]	**170,257,076**	158,623,723

(1) Diluted shares are calculated using the treasury stock method, and include dilutive shares from deferred stock awards. For the three months ended September 30, 2009, the number of shares excluded from diluted shares outstanding were 157,531 shares, because the effect would have been anti-dilutive.

Table of Contents

14. Subsequent Events

Sale of Property Owned in Unconsolidated Joint Venture

On October 15, 2010, Fund IX, X, XI and REIT Joint Venture closed the sale of the 14400 Hertz Quail Springs Parkway Building for a gross sales price of $5.3 million. Piedmont owns approximately four percent of the joint venture, and expects to record its proportionate share of the net sales proceeds and gain on sale in October 2010 of approximately $189,000 and $25,000, respectively. Fund IX, X, XI and REIT Joint Venture, after the completion of the sale, owns one building (360 Interlocken) in Broomfield, Colorado.

Declaration of Dividend for the Fourth Quarter 2010

On November 9, 2010, the board of directors of Piedmont declared dividends for the fourth quarter 2010 in the amount of $0.315 (31.50 cents) per share on all classes of outstanding common shares of Piedmont to stockholders of record as of the close of business on December 1, 2010. Such dividends are to be paid on December 15, 2010.

Table of Contents

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 accompanying consolidated financial statements and notes thereto of Piedmont Office Realty Trust, Inc. (Piedmont). See also Cautionary Note Regarding Forward-Looking Statements preceding Part I, as well as the notes to our consolidated financial statements and Management s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2009.

Liquidity and Capital Resources

We intend to use cash flows generated from the operation of our wholly-owned properties and distributions from our unconsolidated joint ventures, proceeds from our existing $500 Million Unsecured Facility, and proceeds from our upcoming sale of the 111 Sylvan Avenue Building as our primary sources of immediate and long-term liquidity. In addition, the potential selective disposal of existing properties and other financing opportunities (such as issuance of additional equity or debt securities or additional borrowings from third-party lenders) afforded to us based on our relatively low leverage and quality asset base may also provide additional sources of capital; however, the availability and attractiveness of terms for these sources of capital is highly dependent on market conditions. As of the time of this filing, we paid down all outstanding amounts under our $500 Million Unsecured Facility; therefore, we had the full capacity available for future borrowing with the exception of approximately $14.0 million of capacity that is reserved as security for outstanding letters of credit with two tenants and one municipal government.

We anticipate that our most immediate use of capital will be to fund capital expenditures for our existing portfolio of properties. These expenditures include two types of specifically identified building improvement projects: (i) general repair and maintenance projects that we as the owner may choose to perform at any of our various properties, and (ii) tenant improvement allowances and leasing commissions negotiated as part of executed leases with our tenants. The timing and magnitude of general repair and maintenance projects are subject to our discretion. We anticipate funding approximately $114.9 million in unrecorded contractual obligations for tenant improvements related to our existing lease portfolio over the respective lease term, much of which we estimate may be required to be funded over the next five years. For many of our leases, the timing of the actual funding of these tenant improvements is largely dependent upon tenant requests for reimbursement. In some cases, these obligations may expire with the leases without further recourse to us. Finally, projected amounts for tenant improvements and leasing commissions related to anticipated re-leasing efforts are generally expected to increase in the near to medium term as a significant number of our leases are scheduled to expire over the next four years. However, the timing and magnitude of these amounts are subject to change as competitive market conditions at the time of lease negotiations dictate.

Subject to the availability of attractive properties and our ability to consummate additional acquisitions on satisfactory terms, acquiring new assets compatible with our investment strategy could also be a significant use of capital. Although the only near-term debt maturity we have is the $250 Million Unsecured Term Loan in June 2011, we also anticipate using funds to make scheduled debt service payments and/or debt repayments when such obligations become due.

Our cash flows from operations depend significantly on market rents and the ability of our tenants to make rental payments. While we believe the diversity and high credit quality of our tenants help mitigate the risk of a significant interruption of our cash flows from operations, the challenging economic conditions that we are currently experiencing, the downward pressure on rental rates in most of our markets, the potential for an increase in interest rates, or the possibility for a further downturn in one of our concentration markets, could adversely impact our operating cash flows. Our primary focus is to achieve an attractive long-term, risk-adjusted return for our stockholders. Competition to attract and retain high-credit-quality tenants remains intense due to general economic conditions. At the same time, as mentioned above, a significant number of our leases at our properties are scheduled to expire over the next four years, and the capital requirements necessary to maintain our current occupancy levels, including payment of leasing commissions, tenant concessions, and anticipated leasing expenditures, could increase. As such, we will continue to closely monitor our tenant renewals, rental rates, competitive market conditions, and our cash flows. The amount and form of payment (cash or stock issuance) of future dividends to be paid to our stockholders will continue to be largely dependent upon (i) the amount of cash generated from our operating activities, (ii) our expectations of future cash flows, (iii) our determination of near-term cash needs for debt repayments and selective acquisitions of new properties, (iv) the timing of significant expenditures for tenant improvements and general property capital improvements, (v) appropriate long-term payout ratios for comparable companies, (vi) our ability to continue to access additional sources of capital and (vii) the amount required to be distributed to maintain our status as a REIT. Given the fluctuating nature of cash flows and expenditures, we may periodically borrow funds on a short-term basis to cover timing differences in cash collections and cash receipts; however, if our cash flow forecasts indicate an extended outflow of cash, we will consider adjusting our dividend policy accordingly.

Table of Contents

Results of Operations

Overview

Our income from continuing operations for each period presented increased as compared to the prior year, primarily due to the presence of lease termination income during the current periods, as well as the non-recurrence of impairment charges on assets held for use in the prior year. The positive effect of decreases in our property operating expenses, including lower estimated property tax assessments, as compared to prior periods were partially offset by lower tenant reimbursements associated with such expense.

Comparison of the three months ended September 30, 2010 versus the three months ended September 30, 2009

The following table sets forth selected data from our consolidated statements of income for the three months ended September 30, 2010 and 2009, respectively, as well as each balance as a percentage of total revenues for the same periods presented (dollars in millions):

	September 30, 2010	%	September 30, 2009	%	$ Increase (Decrease)
Revenue:					
Rental income	**$ 110.8**		$ 111.3		(0.5)
Tenant reimbursements	**29.7**		36.9		(7.2)
Property management fee revenue	**0.8**		0.7		0.1
Other rental income	**4.2**				4.2
Total revenues	**145.5**	100%	148.9	100%	(3.4)
Expense:					
Property operating costs	**46.6**	32%	57.6	39%	(11.0)
Depreciation	**26.0**	18%	26.4	18%	(0.4)
Amortization	**11.0**	7%	14.0	9%	(3.0)
General and administrative expense	**6.8**	5%	5.6	4%	1.2
Impairment loss on real estate assets		0%	35.1	23%	(35.1)
Real estate operating income	**55.1**	38%	10.2	7%	44.9
Other income (expense):					
Interest expense	**(17.4)**	12%	(19.5)	13%	(2.1)
Interest and other income	**1.0**	1%	2.0	1%	(1.0)
Equity in income of unconsolidated joint ventures	**0.6**	0%	(2.0)	1%	2.6
Income from continuing operations	**$ 39.3**	27%	$ (9.3)	6%	48.6

Continuing Operations

Revenue

Rental income decreased from approximately $111.3 million for the three months ended September 30, 2009 to approximately $110.8 million for the three months ended September 30, 2010. This variance relates primarily to a non-recurring adjustment to rental income in 2009 at our 3100 Clarendon Boulevard Building in Washington, D.C. to recognize an increase in rental income and parking fees for a tenant that renewed its lease at higher rates, which were retroactive to June 2008. The decrease was partially offset by an adjustment to accelerate straight-line rental revenue in the prior period related to a lease termination at the Chandler Forum Building in Phoenix, Arizona. Tenant reimbursements decreased from approximately $36.9 million for the three months ended September 30, 2009 to approximately $29.7 million for the three months ended September 30, 2010 primarily due to lower recoverable estimated property taxes of approximately $7.4 million at several of our buildings.

Other rental income is comprised primarily of income recognized for lease terminations and restructurings. Unlike the majority of our rental income, which is recognized ratably over long-term contracts, other rental income is recognized once we have completed our obligation to provide space to the tenant. Lease terminations and restructurings for the three months ended September 30, 2010 of approximately $4.2 million primarily relates to leases terminated at the Chandler Forum Building, the 110 Hidden Lake Circle Building in Duncan, South Carolina, and the Sarasota Commerce Center II Building in Sarasota, Florida. We do not expect such income to be comparable in future periods, as it will be dependent upon the exercise of lease terminations by tenants and/or the execution of restructuring agreements that may not be in our control or are deemed by management to be in the best interest of the portfolio over the long term.

Table of Contents

Expense

Property operating costs decreased approximately $11.0 million for the three months ended September 30, 2010 compared to the same period in the prior year. This variance is primarily the result of successful appeals of the assessed values at several of our buildings resulting in lower estimated property tax expense of approximately $11.9 million. This favorable variance was partially offset by higher recoverable tenant-requested services (i.e., billback expenses) of approximately $0.4 million and higher non-recoverable property operating costs of approximately $0.4 million, mostly due to utility and repair costs.

Depreciation expense decreased approximately $0.4 million for the three months ended September 30, 2010 compared to the same period in the prior year. The decrease in depreciation is largely due to an adjustment to accelerate depreciation expense on tenant improvements in the prior period related to a lease termination at the Chandler Forum Building. The decrease was partially offset by an increase in tenant improvements placed in service subsequent to September 30, 2009 at various buildings within the portfolio.

Amortization expense decreased approximately $3.0 million for the three months ended September 30, 2010 compared to the same period in the prior year. The decrease primarily relates to lease intangible assets that have fully amortized subsequent to September 30, 2009, as well as prior period adjustments to accelerate amortization expense due to lease terminations at our 3100 Clarendon Boulevard Building and our Chandler Forum Building of approximately $0.5 million. This decrease during the current period was partially offset by an increase in amortization related to new deferred lease acquisition costs associated with the acquisition or renewal of tenants, which is amortized over the life of the respective leases.

General and administrative expenses increased approximately $1.2 million for the quarter ended September 30, 2010 compared to the same period in the prior year. The increase is primary attributable to an increase in transfer agent expenses associated with our recent recapitalization, listing of our shares on the New York Stock Exchange, and related investor support expenses. We also incurred higher employee benefit costs of approximately $0.5 million primarily due to the modification of our long-term incentive compensation plan during the current period, which resulted in earlier recognition of expense as compared to the prior year.

We did not recognize an impairment loss on our held-for-use, wholly-owned buildings during the current year; however, during the quarter ended September 30, 2009, we recognized an impairment loss of approximately $35.1 million as a result of lowering expected future rental income and reducing the intended holding periods for the Auburn Hills Corporate Center Building in Auburn Hills, Michigan, and the 1441 West Long Lake Road Building in Troy, Michigan, as well as the 1111 Durham Avenue Building in South Plainfield, New Jersey. The decision to reduce projected future rental revenues and the holding periods for the two Detroit assets was prompted by the loss of prospective replacement tenants and overall declines in demand for office space in the Detroit, Michigan market. Further, changes in management s expectation of re-leasing prospects of the New Jersey asset, coupled with general market declines in the South Plainfield submarket in which it is located, prompted the reduction of the intended holding period and future rental revenues during the quarter ended September 30, 2009. The cumulative effect of these decisions triggered a reassessment of leasing assumptions for these buildings, which entailed, among other things, evaluating market rents, leasing costs and the downtime necessary to complete the necessary re-leasing activities.

Other Income (Expense)

Interest expense decreased approximately $2.1 million for the three months ended September 30, 2010 compared to the same period in the prior year because we extended the $250 Million Term Loan in June 2010, and entered into new interest rate swap agreements with four counterparties to effectively fix the interest rate on the loan at 2.36%, as compared to 4.97% in 2009. The decrease is also attributable to lower net borrowings on our $500 Million Unsecured Facility during the current year due to the receipt of approximately $184.4 million in net offering proceeds in February 2010.

Interest and other income decreased approximately $1.0 million for the three months ended September 30, 2010 compared to the same period in the prior year. The variance is due to a non-recurring settlement of an acquisition contingency in our favor for an acquisition which closed in 2003 of approximately $0.8 million. Piedmont also received approximately $0.2 million more interest income in the prior year, mainly from Piedmont s two investments in mezzanine debt, both of which are secured by a pledge of the equity interest of the entity owning a 46-story, Class A, commercial office building located in downtown Chicago, Illinois.

Equity in income of unconsolidated joint ventures increased approximately $2.6 million for the three months ended September 30, 2010 compared to the same period in the prior year. The increase was a result of recognizing other-than-temporary impairment of the joint venture which owns the 47320 Kato Road Building in Fremont, California of approximately $2.6 million in the prior period. We expect equity in income of unconsolidated joint ventures to fluctuate based on the timing and extent to which dispositions occur as our unconsolidated joint ventures approach their stated dissolution periods.

Income/(loss) from continuing operations per share on a fully diluted basis increased from a $(0.06) loss for the three months ended September 30, 2009 to income of $0.22 for the three months ended September 30, 2010 primarily as a result of the impairment loss incurred in the prior period; as well as lower operating expenses primarily related to lower estimated property tax assessments at several of our buildings, and approximately $4.2 million of termination fee income included in other rental income recognized during the current period.

Discontinued Operations

In accordance with GAAP, we have classified the operations of the held for sale asset, the 111 Sylvan Avenue Building in Englewood Cliffs, New Jersey, as discontinued operations for all periods presented. Income from discontinued operations was approximately $1.4 million and $1.1 million for the three months ended September 30, 2010 and 2009, respectively. The favorable variance is due to the fact that depreciation is discontinued once the asset becomes classified as held for sale, which occurred on May 5, 2010. We do not expect that income from discontinued operations will be comparable to future periods, as such income is subject to the timing and existence of future property dispositions.

Comparison of the nine months ended September 30, 2010 versus the nine months ended September 30, 2009

The following table sets forth selected data from our consolidated statements of income for the nine months ended September 30, 2010 and 2009, respectively, as well as each balance as a percentage of total revenues for the same periods presented (dollars in millions):

	September 30, 2010	%	September 30, 2009	%	$ Increase (Decrease)
Revenue:					
Rental income	$ **331.9**		$ 333.0		(1.1)
Tenant reimbursements	**98.1**		113.1		(15.0)
Property management fee revenue	**2.3**		2.2		0.1
Other rental income	**5.2**		0.8		4.4
Total revenues	**437.5**	100%	449.1	100%	(11.6)
Expense:					
Property operating costs	**157.4**	36%	173.3	39%	(15.9)
Depreciation	**77.3**	18%	77.8	17%	(0.5)
Amortization	**33.4**	7%	41.1	9%	(7.7)
General and administrative expense	**21.4**	5%	21.1	5%	0.3
Impairment loss on real estate assets		0%	35.1	8%	(35.1)
Real estate operating income	**148.0**	34%	100.7	22%	47.3
Other income (expense):					
Interest expense	**(55.4)**	13%	(58.3)	13%	(2.9)
Interest and other income	**3.0**	1%	3.8	1%	(0.8)
Equity in income of unconsolidated joint ventures	**2.0**	0%	(0.6)	0%	2.6
Income from continuing operations	$ **97.6**	22%	$ 45.6	10%	52.0

Continuing Operations

Revenue

Rental income decreased from approximately $333.0 million for the nine months ended September 30, 2009 to approximately $331.9 million for the nine months ended September 30, 2010. This decrease relates primarily to lower occupancy during the current period at our Aon Center Building in Chicago, Illinois, the 110 Hidden Lake Circle Building in Duncan, South Carolina, and the 1901 Main Street Building in Irvine, California. The unfavorable decrease was partially offset by an increase in occupancy at our Glenridge Highlands Two Building in Atlanta, Georgia as well as higher rental rates at our 60 Broad Street Building in New York, New York. Tenant reimbursements decreased from approximately $113.1 million for the nine months ended September 30, 2009 to approximately $98.1 million for the nine months ended September 30, 2010 primarily due to lower recoverable estimated property taxes of approximately $9.2 million at several of our buildings. The decrease is also attributable to lower recoverable tenant-requested services and utility costs totaling approximately $2.8 million, as well as an overall reduction in recoverable expenses due to a partial lease termination at the Aon Center Building.

Other rental income is comprised primarily of income recognized for lease terminations and restructurings. Unlike the majority of our rental income, which is recognized ratably over long-term contracts, other rental income is recognized once we have completed our obligation to provide space to the tenant. Lease terminations and restructurings for the nine months ended September 30, 2010 of approximately $1.2 million primarily relates to a lease terminated at the 110 Hidden Lake Circle Building and approximately $3.4 million relates to a lease termination at our Chandler Forum Building. Prior year other rental income relates primarily to leases terminated at the 1901 Main Street Building and the Auburn Hills Corporate Center Building of approximately $0.5 million and $0.2 million, respectively. We do not expect such income to be comparable in future periods, as it will be dependent upon the exercise of lease terminations by tenants and/or the execution of restructuring agreements that may not be in our control or are deemed by management to be in the best interest of the portfolio over the long term.

Expense

Property operating costs decreased approximately $15.9 million for the nine months ended September 30, 2010 compared to the same period in the prior year. This variance is primarily the result of successful appeals of the assessed values at several of our buildings resulting in lower estimated property tax expense of approximately $12.8 million. This decrease was also the result of lower recoverable tenant-requested services (i.e., billback expenses) of approximately $1.5 million and lower recoverable utility costs of approximately $1.2 million.

Depreciation expense decreased approximately $0.5 million for the nine months ended September 30, 2010 compared to the same period in the prior year. The decrease in depreciation is largely due to an adjustment to accelerate depreciation expense on tenant improvements in the prior period related to a lease termination at the Chandler Forum Building and the 1901 Main Street Building. The decrease was partially offset by an increase in other tenant improvements placed in service after September 30, 2009 at various buildings within the portfolio.

Amortization expense decreased approximately $7.7 million for the nine months ended September 30, 2010 compared to the same period in the prior year. The decrease primarily relates to lease intangible assets that have fully amortized subsequent to January 1, 2009. However, this decrease during the current period was partially offset by an increase in amortization related to new deferred lease acquisition costs associated with the acquisition or renewal of tenants subsequent to September 30, 2009, which are amortized over the life of the respective leases.

General and administrative expenses increased approximately $0.3 million for the nine months ended September 30, 2010 compared to the same period in the prior year. The increase is primary attributable to an increase in transfer agent expenses associated with our recent recapitalization, listing of our shares on the New York Stock Exchange, and related investor support services. We also incurred higher employee benefit costs due to the modification of our long-term incentive compensation plan during the current period, which resulted in earlier recognition of expense as compared to the prior year. The increase was partially offset by lower tax and registration fees, as well as insurance recoveries related to our defense of ongoing litigation during the current period.

We did not recognize an impairment loss on our held-for-use, wholly-owned buildings during the current year; however, during the nine months ended September 30, 2009, we recognized an impairment loss of approximately $35.1 million as a result of lowering expected future rental income and reducing the intended holding periods for the Auburn Hills Corporate Center Building in Auburn Hills, Michigan, and the 1441 West Long Lake Road Building in Troy, Michigan, as well as the 1111 Durham Avenue Building in South Plainfield, New Jersey. The decision to reduce projected future rental revenues and the holding periods for the two Detroit assets was prompted by the loss of prospective replacement tenants and overall declines in demand for office space in the Detroit, Michigan market. Further, changes in management s expectation of re-leasing prospects of the New Jersey asset, coupled with general market declines in the South Plainfield submarket in which it is located, prompted the reduction of the intended holding period and future rental revenues during the nine months ended September 30, 2009. The cumulative effect of these decisions triggered a reassessment of leasing assumptions for these buildings, which entailed, among other things, evaluating market rents, leasing costs and the downtime necessary to complete the necessary re-leasing activities.

Other Income (Expense)

Interest expense decreased approximately $2.9 million for the nine months ended September 30, 2010 compared to the same period in the prior year. When we extended the $250 Million Term Loan in June 2010, we entered into new interest rate swap agreements with four counterparties to effectively fix the rate on the $250 Million Unsecured Term Loan at 2.36% compared to the prior rate of 4.97% in 2009. The decrease is also attributable to lower net borrowings on our $500 Million Unsecured Facility in the current year due to the receipt of approximately $184.4 million in net offering proceeds in February 2010.

26

Interest and other income decreased approximately $0.8 million for the nine months ended September 30, 2010 compared to the same period in the prior year. The variance is attributable to a non-recurring settlement of an acquisition contingency in our favor for an acquisition which closed in 2003.

Equity in income of unconsolidated joint ventures increased approximately $2.6 million for the nine months ended September 30, 2010 compared to the same period in the prior year. The increase was a result of recognizing other-than-temporary impairment of a joint venture which owns the 47320 Kato Road Building in Fremont, California of approximately $2.6 million in the prior period. We expect equity in income of unconsolidated joint ventures to fluctuate based on the timing and extent to which dispositions occur as our unconsolidated joint ventures approach their stated dissolution periods.

Income from continuing operations per share on a fully diluted basis increased from $0.29 for the nine months ended September 30, 2009 to $0.57 for the nine months ended September 30, 2010 primarily as a result of the impairment loss incurred in the prior period. We also recognized higher other rental income in the current period due to income recognized for lease terminations and restructurings, as well as lower operating expenses primarily related to lower estimated property tax assessments at several of our buildings, and lower interest expense.

Discontinued Operations

In accordance with GAAP, we have classified the operations of the held for sale asset, the 111 Sylvan Avenue Building, as discontinued operations for all periods presented. (Loss)/income from discontinued operations was approximately $(5.5) million and $3.5 million for the nine months ended September 30, 2010 and 2009, respectively. Loss from discontinued operations during the current year is the result of recognizing an impairment charge of approximately $9.6 million in conjunction with adjusting the assets to estimated fair value (less costs to sell) upon execution of a binding contract to dispose of the asset. We do not expect that income from discontinued operations will be comparable to future periods, as such income is subject to the timing and existence of future property dispositions.

Funds From Operations (FFO), Core FFO, and Adjusted Funds from Operations (AFFO)

Net income calculated in accordance with GAAP is the starting point for calculating FFO, Core FFO, and AFFO. FFO, Core FFO, and AFFO are non-GAAP financial measures and should not be viewed as an alternative measurement of our operating performance to net income. Management believes that accounting for real estate assets in accordance with GAAP implicitly assumes that the value of real estate assets diminishes predictably over time. Since real estate values have historically risen or fallen with market conditions, many industry investors and analysts have considered the presentation of operating results for real estate companies that use historical cost accounting to be insufficient by themselves. As a result, we believe that the use of FFO, Core FFO, and AFFO, together with the required GAAP presentation, provides a more complete understanding of our performance relative to our competitors and a more informed and appropriate basis on which to make decisions involving operating, financing, and investing activities.

We calculate FFO in accordance with the current NAREIT definition as follows: Net income (computed in accordance with GAAP), excluding gains or losses from sales of property, plus depreciation and amortization on real estate assets (including our proportionate share of depreciation and amortization related to investments in unconsolidated joint ventures). Other REITs may not define FFO in accordance with the NAREIT definition, or may interpret the current NAREIT definition differently than we do; therefore, our computation of FFO may not be comparable to such other REITs.

We calculate Core FFO as FFO (calculated as set forth above) less impairment charges and extraordinary items (including our proportionate share of any impairment charges or extraordinary items recognized during the period related to investments in unconsolidated joint ventures).

For the three months and nine months ended September 30, 2010 and 2009, we calculated AFFO as Core FFO (calculated as set forth above) exclusive of the net effects of: (i) amortization associated with deferred financing costs; (ii) depreciation on non-income-producing real estate assets; (iii) straight-line lease revenue/expense; (iv) amortization of above and below-market lease intangibles;

Table of Contents

(v) stock-based and other non-cash compensation expense; (vi) amortization of mezzanine discount income; and (vii) non-incremental capital expenditures (as defined below). Our proportionate share of such adjustments related to investments in unconsolidated joint ventures are also included when calculating AFFO.

Reconciliations of net income to FFO, Core FFO, and AFFO are presented below (in thousands except per share amounts):

	Three Months Ended September 30				Nine Months Ended September 30			
	2010	Per Share[(1)]	2009	Per Share[(1)]	2010	Per Share[(1)]	2009	Per Share[(1)]
Net income attributable to Piedmont	**$ 40,584**	**$ .23**	$ (8,260)	$ (.05)	**$ 91,679**	**$ .54**	$ 48,754	$ .31
Depreciation of real assets [(2)]	**26,163**	**.15**	27,004	.17	**78,285**	**.46**	79,614	.50
Amortization of lease-related costs [(2)]	**11,119**	**.07**	14,094	.09	**33,711**	**.20**	41,434	.26
Funds From Operations	**$ 77,866**	**$ .45**	$ 32,838	$ .21	**$ 203,675**	**$ 1.20**	$ 169,802	$ 1.07
Adjustment:								
Impairment loss	**53**		37,633	.24	**9,641**	**.05**	37,633	.24
Core Funds From Operations	**$ 77,919**	**$ .45**	$ 70,471	$ .45	**$ 213,316**	**$ 1.25**	$ 207,435	$ 1.31
Deferred financing cost amortization	**607**	**.01**	696		**2,000**	**.01**	2,090	.01
Depreciation of non real estate assets	**176**		155		**533**		461	
Straight-line effects of lease (revenue)/expense [(2)]	**(2,921)**	**(.02)**	(847)		**(2,632)**	**(.01)**	622	
Stock-based and other non-cash compensation	**1,095**	**.01**	671		**2,458**	**.02**	2,506	.02
Net effect of amortization of below-market in-place lease intangibles [(2)]	**(1,510)**	**(.01)**	(1,283)	(.01)	**(4,461)**	**(.03)**	(3,736)	(.02)
Income from amortization of discount on purchase of mezzanine loans	**(569)**		(648)		**(1,932)**	**(.01)**	(1,944)	(.01)
Non-incremental capital expenditures [(3)]	**(13,329)**	**(.08)**	(7,851)	(.05)	**(31,712)**	**(.19)**	(26,478)	(.17)
Adjusted Funds From Operations	**$ 61,468**	**$ .36**	$ 61,364	$ .39	**$ 177,570**	**$ 1.04**	$ 180,956	$ 1.14
Weighted-average shares outstanding diluted	**172,885**		157,603		**170,257**		158,624	

(1) Based on weighted average shares outstanding diluted.
(2) Includes adjustments for wholly-owned properties, as well as such adjustments for our proportionate ownership in unconsolidated joint ventures.
(3) Represents capital expenditures of a recurring nature related to tenant improvements and leasing commissions that do not incrementally enhance the underlying assets income generating capacity. First generation tenant improvements and leasing commissions are excluded from this measure.

Election as a REIT

We have elected to be taxed as a REIT under the Code and have operated as such beginning with our taxable year ended December 31, 1998. To qualify as a REIT, we must meet certain organizational and operational requirements, including a requirement to distribute at least 90% of our adjusted REIT taxable income, computed without regard to the dividends-paid deduction and by excluding net capital gains attributable to our stockholders, as defined by the Code. As a REIT, we generally will not be subject to federal income tax on income that we distribute to our stockholders; however, we are subject to certain state and local taxes related to the operations of properties in certain locations, which have been provided for in our accompanying consolidated financial statements.

If we fail to qualify as a REIT in any taxable year, we may be subject to federal income taxes on our taxable income for that year and for the four years following the year during which qualification is lost and/or penalties, unless the IRS grants us relief under certain statutory provisions. Such an event could materially adversely affect our net income and net cash available for distribution to our stockholders. However, we believe that we are organized and operate in such a manner as to qualify for treatment as a REIT and intend to continue to operate in the foreseeable future in such a manner that we will remain qualified as a REIT for federal income tax purposes.

Table of Contents

We have elected to treat Piedmont Office Holdings, Inc. (POH), a wholly-owned subsidiary of Piedmont, as a taxable REIT subsidiary. We may perform non-customary services for tenants of buildings that we own, including any real estate or non-real estate related-services; however, any earnings related to such services performed by our taxable REIT subsidiary are subject to federal and state income taxes. In addition, for us to continue to qualify as a REIT, our investments in taxable REIT subsidiaries cannot exceed 25% of the value of our total assets. As POH had no significant operations for the nine months ended September 30, 2010, and we made distributions in excess of taxable income for the periods presented, no provision for federal income taxes has been made in our accompanying consolidated financial statements.

Inflation

We are exposed to inflation risk, as income from long-term leases is the primary source of our cash flows from operations. There are provisions in the majority of our tenant leases that are intended to protect us from, and mitigate the risk of, the impact of inflation. These provisions include rent steps, reimbursement billings for operating expense pass-through charges, real estate tax, and insurance reimbursements on a per square-foot basis, or in some cases, annual reimbursement of operating expenses above certain per square-foot allowances. However, due to the long-term nature of the leases, the leases may not readjust their reimbursement rates frequently enough to fully cover all aspects of inflation.

Application of Critical Accounting Policies

Our accounting policies have been established to conform with GAAP. The preparation of financial statements in conformity with GAAP requires us to use judgment in the application of accounting policies, including making estimates and assumptions. These judgments affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. If our judgment or interpretation of the facts and circumstances relating to various transactions had been different, it is possible that different accounting policies would have been applied, thus resulting in a different presentation of the financial statements. Additionally, other companies may utilize different estimates that may impact comparability of our results of operations to those of companies in similar businesses.

Investment in Real Estate Assets

We are required to make subjective assessments as to the useful lives of our depreciable assets. We consider the period of future benefit of the asset to determine the appropriate useful lives. These assessments have a direct impact on net income attributable to Piedmont. The estimated useful lives of our assets by class are as follows:

Buildings	40 years
Building improvements	5-25 years
Land improvements	20-25 years
Tenant improvements	Shorter of economic life or lease term
Intangible lease assets	Lease term

Allocation of Purchase Price of Acquired Assets

Upon the acquisition of real properties, it is our policy to allocate the purchase price of properties to acquired tangible assets, consisting of land and building, and identified intangible assets and liabilities, consisting of the value of above-market and below-market leases, other value of in-place leases, and value of tenant relationships, based in each case on their estimated fair values.

The fair values of the tangible assets of an acquired property (which includes land and buildings) are determined by valuing the property as if it were vacant, and the as-if-vacant value is then allocated to land and building based on our determination of the fair value of these assets. We determine the as-if-vacant fair value of a property using methods similar to those used by independent appraisers. Factors considered by us in performing these analyses include an estimate of carrying costs during the expected lease-up periods considering current market conditions and costs to execute similar leases. In estimating carrying costs, we include real estate taxes, insurance, and other operating expenses and estimates of lost rental revenue during the expected lease-up periods based on current market demand. We also estimate the cost to execute similar leases including leasing commissions, legal, and other related costs.

The fair values of above-market and below-market in-place lease values are recorded based on the present value (using an interest rate that reflects the risks associated with the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) our estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining noncancelable term of the lease. The above-market and below-market lease values are capitalized as intangible lease assets and liabilities and amortized as an adjustment of rental income over the remaining terms of the respective leases.

The fair values of in-place leases include direct costs associated with obtaining a new tenant, opportunity costs associated with lost rentals that are avoided by acquiring an in-place lease, and tenant relationships. Direct costs associated with obtaining a new tenant include commissions, tenant improvements, and other direct costs and are estimated based on management s consideration of current market costs to execute a similar lease. These direct costs are included in deferred lease costs in the accompanying consolidated balance sheets and are amortized to expense over the remaining terms of the respective leases. The value of opportunity costs is calculated using the contractual amounts to be paid pursuant to the in-place leases over a market absorption period for a similar lease. Customer relationships are valued based on expected renewal of a lease or the likelihood of obtaining a particular tenant for other locations. These lease intangibles are included in intangible lease assets in the accompanying consolidated balance sheets and are amortized to expense over the remaining terms of the respective leases.

Estimates of the fair values of the tangible and intangible assets require us to estimate market lease rates, property operating expenses, carrying costs during lease-up periods, discount rates, market absorption periods, and the number of years the property is held for investment. The use of inappropriate estimates would result in an incorrect assessment of our purchase price allocations, which could impact the amount of our reported net income attributable to Piedmont.

Valuation of Real Estate Assets and Investments in Joint Ventures Which Hold Real Estate Assets

We continually monitor events and changes in circumstances that could indicate that the carrying amounts of the real estate and related intangible assets, both operating properties and properties under construction, in which we have an ownership interest, either directly or through investments in joint ventures, may not be recoverable. When indicators of potential impairment are present which indicate that the carrying amounts of real estate and related intangible assets may not be recoverable, we assess the recoverability of these assets by determining whether the carrying value will be recovered through the undiscounted future operating cash flows expected from the use of the asset and its eventual disposition. In the event that such expected undiscounted future cash flows do not exceed the carrying value, we adjust the real estate and related intangible assets to the fair value and recognize an impairment loss.

Projections of expected future cash flows require that we estimate future market rental income amounts subsequent to the expiration of current lease agreements, property operating expenses, the number of months it takes to re-lease the property, and the number of years the property is held for investment, among other factors. The subjectivity of assumptions used in the future cash flow analysis, including discount rates, could result in an incorrect assessment of the property s fair value and, therefore, could result in the misstatement of the carrying value of our real estate and related intangible assets and our net income attributable to Piedmont. We have determined that other than the impairment charge recognized during the second quarter of 2010 upon execution of a binding agreement to dispose of the 111 Sylvan Avenue Building of approximately $9.6 million (see Note 11), and our proportionate share of a charge taken on a building (360 Interlocken) owned through an unconsolidated joint venture which was deemed other than temporary in nature of approximately $53,000 (see Note 9), there has been no impairment in the carrying value of real estate assets owned by us or any unconsolidated joint ventures as of September 30, 2010.

Goodwill

Goodwill is the excess of cost of an acquired entity over the amounts specifically assigned to assets acquired and liabilities assumed in purchase accounting for business combinations, as well as costs incurred as part of the acquisition. We test the carrying value of our goodwill for impairment on an annual basis, or on an interim basis if an event occurs or circumstances change that would indicate the carrying amount may be impaired. Such interim circumstances may include, but are not limited to, significant adverse changes in legal factors or in the general business climate, adverse action or assessment by a regulator, unanticipated competition, the loss of key personnel, or persistent declines in an entity s stock price below carrying value of the entity. The test prescribed by authoritative accounting guidance is a two-step test. The first step involves comparing the estimated fair value of the entity to its carrying value, including goodwill. Fair value is determined by adjusting the trading price of the stock for various factors including, but not limited to: (i) liquidity or transferability considerations, (ii) control premiums, and/or (iii) fully distributed premiums, if necessary, multiplied by the common shares outstanding. If such calculated fair value exceeds the carrying value, no further procedures or analysis is permitted or required. However, if the carrying value exceeds the calculated fair value, goodwill is potentially impaired and step two of the analysis would be required. Step two of the test involves calculating the implied fair value of goodwill by deducting the fair value of all tangible and intangible net assets of the entity from the entity s fair value calculated in step one of the test. If the implied value of the goodwill (the remainder left after deducting the fair values of the entity from its calculated overall fair value in step one of the test) is less than the carrying value of goodwill, an impairment loss would be recognized. We have determined that there have been no events or circumstances that would indicate that the carrying amount may be impaired as of September 30, 2010.

Investment in Variable Interest Entities

Variable Interest Entities (VIEs) are defined by GAAP as entities in which equity investors do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. If an entity is determined to be a VIE, it must be consolidated by the primary beneficiary. The primary beneficiary is the enterprise that has the power to direct the activities of the VIE that most significantly impact the VIE s economic performance, absorbs the majority of the entity s expected losses, or receives a majority of the entity s expected residual returns. Generally, expected losses and expected residual returns are the anticipated negative and positive variability, respectively, in the fair value of the VIE s net assets. When we make an investment, we assess whether the investment represents a variable interest in a VIE and, if so, whether we are the primary beneficiary of the VIE. Incorrect assumptions or assessments may result in an inaccurate determination of the primary beneficiary. The result could be the consolidation of an entity acquired or formed in the future that would otherwise not have been consolidated or the non-consolidation of such an entity that would otherwise have been consolidated.

We evaluate each investment to determine whether it represents variable interests in a VIE. Further, we evaluate the sufficiency of the entities equity investment at risk to absorb expected losses, and whether as a group, the equity has the characteristics of a controlling financial interest.

Interest Rate Swap

When we enter into an interest rate swap agreement to hedge our exposure to changing interest rates on our variable rate debt instruments, as required by GAAP, we record all derivatives on the balance sheet at fair value. We reassess the effectiveness of our derivatives designated as cash flow hedges on a regular basis to determine if they continue to be highly effective and also to determine if the forecasted transactions remain highly probable. The changes in fair value of derivatives designated as cash flow hedges are recorded in other comprehensive income (OCI), and the amounts in OCI will be reclassified to earnings when the hedged transactions occur. Changes in the fair values of derivatives designated as cash flow hedges that do not qualify for hedge accounting treatment are recorded as gain/(loss) on interest rate swap in the consolidated statements of operations in the current period. The fair value of the interest rate swap agreement is recorded as prepaid expenses and other assets or as interest rate swap liability in the accompanying consolidated balance sheets. Amounts received or paid under interest rate swap agreements are recorded as interest expense in the consolidated statements of operations as incurred. Currently, we do not use derivatives for trading or speculative purposes and do not have any derivatives that are not designated as cash flow hedges.

Contractual Obligations

Our contractual obligations as of September 30, 2010 are as follows (in thousands):

	Payments Due by Period				
Contractual Obligations	**Total**	**Less than 1 year**	**1-3 years**	**4-5 years**	**More than 5 years**
Long-term debt [(1)]	$ 1,402,525	$ 250,000	$ 45,000	$ 800,000	$ 307,525
Operating lease obligations[(2)]	79,266	624	2,184	1,404	75,054
Total	$ 1,481,791	$ 250,624	$ 47,184	$ 801,404	$ 382,579

(1) Amounts include principal payments only. We made interest payments, including payments under our interest rate swaps, of approximately $52.9 million during the nine months ended September 30, 2010, and expect to pay interest in future periods on outstanding debt obligations based on the rates and terms disclosed herein and in Note 6 of our accompanying consolidated financial statements.

(2) Three properties (the River Corporate Center Building in Tempe, Arizona; the 8700 South Price Road Building in Tempe, Arizona; and the 2001 NW 64th Street Building in Ft. Lauderdale, Florida) are subject to ground leases with expiration dates ranging between 2048 and 2101. The aggregate remaining payments required under the terms of these operating leases as of September 30, 2010 are presented above.

Commitments and Contingencies

We are subject to certain commitments and contingencies with regard to certain transactions. Refer to Note 10 to our consolidated financial statements for further explanation. Examples of such commitments and contingencies include:

Commitments Under Existing Lease Agreements;

Contingencies Related to Tenant Audits; and

Table of Contents

Assertion of Legal Action.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our future income, cash flows, and fair values of our financial instruments depend in part upon prevailing market interest rates. Market risk is the exposure to loss resulting from changes in interest rates, foreign currency, exchange rates, commodity prices, and equity prices. Our exposure to market risk includes interest rate fluctuations in connection with any borrowings under our $500 Million Unsecured Facility and our $250 Million Unsecured Term Loan. As a result, the primary market risk to which we believe we are exposed is interest rate risk. Many factors, including governmental monetary and tax policies, domestic and international economic and political considerations, and other factors that are beyond our control contribute to interest rate risk. Our interest rate risk management objectives are to limit the impact of interest rate changes on earnings and cash flow primarily through a low-to-moderate level of overall borrowings, as well as managing the variability in rate fluctuations on our outstanding debt. As such, a significant portion of our debt is based on fixed interest rates to hedge against instability in the credit markets, and we have effectively fixed the interest rate on our $250 Million Unsecured Term Loan through interest rate swap agreements.

All of our debt was entered into for other than trading purposes, and the estimated fair value of our debt as of September 30, 2010 was approximately $1.4 billion. See Note 8 of our accompanying consolidated financial statements for further detail.

As of September 30, 2010, all of our outstanding debt is subject to fixed, or effectively fixed, interest rates. Our total outstanding debt has an average interest rate of approximately 4.66% per annum with expirations ranging from 2011 to 2017. A change in the market interest rate impacts the net financial instrument position of our fixed-rate debt portfolio but has no impact on interest incurred or cash flows. Such agreements may result in higher fixed interest rates in certain periods of lower variable interest rates, but are intended to decrease our exposure to potential increases in interest rates.

As of September 30, 2010, we had no amounts outstanding on our $500 Million Unsecured Facility, which is the only debt facility subject to variable interest rates. Our $500 Million Unsecured Facility currently has a stated rate of LIBOR plus 0.475% per annum or the prime rate, at the company s discretion. The 30-day LIBOR rate as of September 30, 2010 was 0.26%. On October 1, 2010, we borrowed approximately $25.0 million under this facility in conjunction with closing of the One and Two Meridian Crossings Buildings. To the extent that we borrow additional funds in the future under the $500 Million Unsecured Facility or potential future variable-rate lines of credit, we would have exposure to increases in interest rates, which would potentially increase our cost of debt.

ITEM 4. CONTROLS AND PROCEDURES

Management s Conclusions Regarding the Effectiveness of Disclosure Controls and Procedures

We carried out an evaluation, under the supervision and with the participation of management, including the Principal Executive Officer and the Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as defined in Rule 15d-15(e) of the Securities Exchange Act of 1934 (the Exchange Act) as of the end of the quarterly period covered by this report. Based upon that evaluation, the Principal Executive Officer and the Principal Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report in providing a reasonable level of assurance that information we are required to disclose in the reports we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in applicable SEC rules and forms, including providing a reasonable level of assurance that information required to be disclosed by us in the reports we file under the Exchange Act is accumulated and communicated to our management, including the Principal Executive Officer and the Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended September 30, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

For information relating to Piedmont s legal proceedings, see Note 10 of our accompanying consolidated financial statements.

ITEM 1A. RISK FACTORS

We may be required to recognize non-cash losses associated with our potential foreclosure on the security interest related to our notes receivable.

We are currently the lender of two notes receivable, both of which are secured by a pledge of the equity interest of the entity owning a 46-story, Class A, commercial office building located in downtown Chicago (the 500 W. Monroe Building).

The 500 W. Monroe Building is encumbered by a first mortgage (the Mortgage Loan) and four different mezzanine loans (the Mezzanine Loans) held by different lenders. Within the first Mezzanine Loan and the third Mezzanine Loan, there is also a senior and a junior tranche of mezzanine debt. We hold the junior tranche in the first Mezzanine Loan and the entire second Mezzanine Loan. The owner of the 500 W. Monroe Building defaulted on the most junior mezzanine loan in February 2009 and has been operating pursuant to a forbearance agreement with that lender (the most Junior Loan Holder). As of August 9, 2010, all of the loans (Mortgage and Mezzanine, including our two mezzanine loan investments) had matured. We subsequently exercised our right to extend the Mortgage Loan and first priority Mezzanine Loan and issued a notice announcing that a UCC foreclosure sale would be conducted on September 14, 2010 wherein our collateral for our second Mezzanine Loan (the pledge of the equity interest in the borrower under the first Mezzanine Loan) would be auctioned. The owner of the building initiated legal action to prevent the foreclosure auction from taking place and on September 8, 2010, after being denied a restraining order by the New York State Supreme Court, appealed that decision to the Appellate Division in New York, where the appellate court issued a stay order delaying the foreclosure auction pending the adjudication of the borrower s appeal. The matter is still pending resolution in court.

If we are ultimately successful in foreclosing on the property, we will record the fair value of the building, mortgage and surviving mezzanine debt and the related interest rate caps in our consolidated financial statements. In addition, we will be required to write-off the current recorded value of the notes as we would then be both borrower and lender of the notes. Any difference between the fair values of the assets and liabilities recorded would result in non-cash income or expense. In addition, in the event that foreclosure becomes probable, we will remeasure the receivables based on our assessment of the fair value of the collateral at that time.

Other than the risk factor above, there have been no known material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2009.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(a) There were no unregistered sales of equity securities during the third quarter 2010.

(b) Not applicable.

(c) During the quarter ended September 30, 2010, Piedmont s transfer agent repurchased shares of its Class A common stock in the open market, in order to reissue such shares under its dividend reinvestment plan (the DRP), as follows:

Period	Total Number of Shares Purchased (in 000 s)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program (in 000 s) (1)	Maximum Approximate Dollar Value of Shares Available That May Yet Be Redeemed in Calendar Year 2009 Under the Program (in 000 s)(1)
July 1, 2010 to July 31, 2010		$		$
August 1, 2010 to August 31, 2010		$		$
September 1, 2010 to September 30, 2010	33	$ 18.56		$ (1)

(1) Under our DRP, we have the option to either issue shares that we purchase in the open market or issue shares directly from Piedmont from authorized but unissued shares. Such election will take place at the settlement of each quarterly dividend in which there are participants in our DRP, and may change from quarter to quarter based on our judgment of the best use of proceeds for Piedmont. Therefore, repurchases may occur on a quarterly basis, but only to the extent necessary to satisfy DRP elections by our stockholders.

33

Table of Contents

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. RESERVED

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

The Exhibits required to be filed with this report are set forth on the Exhibit Index to Third Quarter 2010 Form 10-Q attached hereto.

Table of Contents

SIGNATURES

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

PIEDMONT OFFICE REALTY TRUST, INC.
(Registrant)

Dated: November 10, 2010

By: /s/ Robert E. Bowers
Robert E. Bowers
Chief Financial Officer and Executive Vice President
(Principal Financial Officer and Duly Authorized Officer)

35

Table of Contents

EXHIBIT INDEX

TO

THIRD QUARTER 2010

FORM 10-Q

OF

PIEDMONT OFFICE REALTY TRUST, INC.

Exhibit Number	Description of Document
3.1	Third Articles of Amendment and Restatement of Piedmont Office Realty Trust, Inc. (the Company) (incorporated by reference to Exhibit 3.1 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2009 filed on March 16, 2010)
3.2	Amended and Restated Bylaws of the Company (incorporated by reference to Exhibit 3.2 to the Company s current Report on Form 8-K filed on January 22, 2010)
31.1	Rule 13a-14(a)/15d-14(a) Certification, executed by Donald A. Miller, CFA, Principal Executive Officer of the Company
31.2	Rule 13a-14(a)/15d-14(a) Certification, executed by Robert E. Bowers, Principal Financial Officer of the Company
32.1	Certification required by Rule 13a-14(b)/15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code, executed by Donald A. Miller, CFA, Chief Executive Officer and President of the Company
32.2	Certification required by Rule 13a-14(b)/15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code, executed by Robert E. Bowers, Chief Financial Officer and Executive Vice-President of the Company